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How the Poor Got Cut Out of Banking

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HOW THE POOR GOT CUT OUT OF BANKING

Mehrsa Baradaran*

ABSTRACT

The United States currently has two banking systems—one for the rich, one for the poor.¹ It was not always this way. In the past, the U.S. government has enlisted certain banking institutions to serve the needs of the poor and offer low-cost credit to enable low-income Americans to escape poverty. Credit unions, savings and loans, and Morris Banks are three prominent examples of government-supported institutions with a specific focus of helping the low-income. Unfortunately, these institutions are no longer fulfilling their missions, and high-cost, usurious, and sometimes predatory check cashers and payday lenders have quickly filled the void. These fringe banks do not provide the poor with useful credit and further bury them in debt.

This Article tracks the neglected history of government-sponsored institutions designed to offer credit to the indigent and explains how each abandoned its initial purpose. In doing so, the Article highlights the shifts in modern banking that rapidly increased competition among banks and caused homogenization in form. Alternative banking institutions could not survive deregulation and were forced to assimilate and operate like mainstream banks, with heightened profits as their sole objective. The poor were the victims.

* Assistant Professor, University of Georgia Law School. The author thanks Arthur Wilmarth, Erik Gerding, Julie Hill, Kristin Johnson, Peter Conti-Brown, Fred Gedicks, David Moore, Usha Rodriguez, and Jared Bybee for their helpful comments on earlier versions of this draft. The author would also like to thank Brad Lowe, Tim Nally, Danny Brimhall, Jonathan Love, and Seth Atkisson for their invaluable research support. All errors are solely those of the author.

¹ The label *poor* is judgment-laden, paternalistic, and an inadequate description of the relevant group of people who are affected by the changes involved in banking. This group includes no-income, low-income, and middle-income individuals who are financially vulnerable in many ways. Poverty is not just about low wages and may not be a permanent condition, and those who are poor do not share common traits. This Article attempts to describe circumstances that affect those that have fewer financial resources and less access relative to others in society. These individuals are often low-income individuals—sometimes minorities or immigrants and sometimes less educated than their more wealthy counterparts—but no single one of these traits is the defining trait of the poor. Although the terms *poor*, *underprivileged*, and *low-income* do not accurately capture this group and have unintended negative connotations, I will use these labels interchangeably throughout the Article.

This Article proposes the reestablishment of government-sponsored banks to serve the poor. Options include redesigning existing government measures and a novel proposal to use the existing Postal Service branches to offer low-cost, short-term credit to the low-income. Such proposals have strong historic roots and could offer credit services to millions of Americans.

INTRODUCTION	485
I. BANKING FOR THE POOR: NEEDS AND BARRIERS	489
A. <i>The Costs of Fringe Banking on the Poor</i>	491
B. <i>Barriers to Banking for the Poor</i>	493
C. <i>Discrimination and Redlining</i>	494
D. <i>The Facade of Informality</i>	495
E. <i>Democratization of Credit?</i>	496
II. WHEN THE POOR HAD BANKS	498
A. <i>Credit Unions</i>	500
1. <i>Born of Necessity</i>	500
2. <i>An Innovative Response</i>	502
3. <i>Embraced by the Law</i>	503
4. <i>Credit Unions Drift from Their Initial Mission</i>	505
5. <i>Deregulation</i>	506
6. <i>Community Development Credit Unions</i>	509
B. <i>Savings and Loans</i>	510
1. <i>Born of Necessity</i>	511
2. <i>An Innovative Response</i>	511
3. <i>Embraced by the Law</i>	512
4. <i>The S&L Drifts from Its Mission</i>	514
5. <i>Deregulation</i>	516
C. <i>Morris Banks and Industrial Loan Companies</i>	519
1. <i>Born of Necessity</i>	519
2. <i>An Innovative Solution</i>	521
3. <i>Embraced by the Law</i>	522
4. <i>Competition from Other Banks and Loss of Mission</i>	523
5. <i>Deregulation</i>	525
D. <i>Common Features of Banks That Served the Poor</i>	525
III. WELCOME TO POTTERSVILLE	526
A. <i>Market Forces</i>	527
B. <i>Financial Deregulation</i>	529
C. <i>Social and Cultural Changes</i>	531
1. <i>The Problem Was Solved</i>	531

a. <i>The Poor Have Access to Credit</i>	532
2. <i>Too Poor to Bank</i>	533
IV. SOLUTIONS FOR BANKING TO THE POOR	533
A. <i>Enlisting Mainstream Banks</i>	533
1. <i>FDIC Pilot Program</i>	533
2. <i>Community Reinvestment Act</i>	535
B. <i>Community Development Banking Act</i>	537
C. <i>Movements Led by the Poor</i>	540
1. <i>Informal Lending Circles</i>	540
2. <i>Formal Lending Circles</i>	542
D. <i>Post Office Banking</i>	544
CONCLUSION	547

INTRODUCTION

Poverty in the United States is rising while economic mobility is declining. A complex variety of factors and circumstances cause poverty, making its alleviation a difficult puzzle for even the most committed policy makers. Pernicious poverty implicates every facet of society and the legal structure, but most obviously, poverty is about money—the lack of it, the inability to make it grow, and the inability to borrow it. Low-income individuals have unique financial needs and challenges and cannot be offered banking services as though they are simply rich people with less money. It is on this front that the U.S. banking system is failing the poor.

A recent study found that over half the population of the United States would not be able to access \$2,000 in thirty days to respond to an emergency.² Further, approximately one-in-four households in the United States (28.3%) are “unbanked”—meaning they have no formal relationship with a bank—or “underbanked”—meaning they do not have access to incremental credit.³ Thus, they must rely on payday lenders, check cashers, or other fringe banking institutions to meet their short-term credit needs. These lenders are often

² *An Examination of the Availability of Credit for Consumers: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 112th Cong. 141 n.1 (2011) [hereinafter *The Availability of Credit Hearing*] (citing Annamaria Lusardi et al., *Financially Fragile Households: Evidence and Implications* (Nat’l Bureau of Econ. Research, Working Paper No. 17072, 2011)) (statement of Robert W. Mooney, Deputy Director, Consumer Protection and Community Affairs).

³ SUSAN BURHOUSE & YAZMIN OSAKI, FDIC, 2011 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 4 (2012).

usurious, sometimes predatory, and almost always much worse for low-income individuals than the services offered by traditional banks to their customers.

Many scholars and policy makers agree that fringe banks have high costs for the poor⁴ and further dislocate them from traditional banking institutions by preventing them from building up a credit history.⁵ Many have advocated regulating such institutions or even banning them.⁶ Proposals include technical regulatory changes aimed at usurious rates,⁷ increased disclosure,⁸ and other consumer protection measures.⁹ Rather than joining the chorus of scholars looking to improve payday lending and check-cashing institutions, this Article takes a more fundamental approach: it seeks to examine the gaping hole that these services are currently filling.

Throughout most of U.S. history, the credit needs of the poor were met by banking institutions specifically created and designed to appeal to them. Credit unions were a populist innovation designed to give the poor control, choice, and ownership over their money, with the protection of federal insurance.¹⁰ The Savings and Loan (S&L) was created to enable middle- and working-class homeownership.¹¹ Each of these institutions was designed as a cooperative: their defining features were common ownership and forbearance of profit.¹² In contrast, the little-known Morris Bank was a for-profit banking venture aimed at the “democratization of credit,” which was envisioned as giving the poor access to small loans.¹³ Credit unions, S&Ls, and Morris Banks operated outside of mainstream banking and used innovative structures and products to meet the unique needs of the poor. Each of these banks was born of necessity,

⁴ See, e.g., JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS, AND THE POOR 7 (1994).

⁵ See, e.g., Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 124 (2004).

⁶ See, e.g., 10 U.S.C. § 987 (2006); N.C. GEN. STAT. § 53-276 (2006); Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 858–60 (2007); Paige Marta Skiba, *Regulation of Payday Loans: Misguided?*, 69 WASH. & LEE L. REV. 1023, 1043 (2012) (stating that fourteen states completely ban payday loans); Scott A. Hefner, Note, *Payday Lending in North Carolina: Now You See It, Now You Don't*, 11 N.C. BANKING INST. 263, 285–87 (2007).

⁷ Pearl Chin, Note, *Payday Loans: The Case for Federal Legislation*, 2004 U. ILL. L. REV. 723, 744.

⁸ Mary Spector, *Taming the Beast: Payday Loans, Regulatory Efforts, and Unintended Consequences*, 57 DEPAUL L. REV. 961, 978–79 (2008).

⁹ See, e.g., Barr, *supra* note 5, at 129; Brian M. McCall, *Unprofitable Lending: Modern Credit Regulation and the Lost Theory of Usury*, 30 CARDOZO L. REV. 549, 551 (2008); Benjamin D. Faller, Note, *Payday Loan Solutions: Slaying the Hydra (and Keeping It Dead)*, 59 CASE W. RES. L. REV. 125, 126 (2008).

¹⁰ See *infra* Part II.A and accompanying notes.

¹¹ See *infra* Part II.B and accompanying notes.

¹² See *infra* Part II.A–B.

¹³ See *infra* Part II.C.

eventually supported by the government, and expanded across the country. Each then drifted from its initial mission.

The drift resulted in part from deregulation. Before the 1980s, the federal and state governments tightly controlled banking by limiting the activities banks could perform.¹⁴ Due to changes in both capital markets and political ideologies, banks began to expand their reach and activities.¹⁵ The banking sector quickly grew in size and scope and lobbied successfully for decreased government regulation.¹⁶ Credit unions, S&Ls, and Morris Banks were caught up in the deregulatory atmosphere of the 1980s and started to compete with mainstream banks for business and customers.¹⁷ This led to a convergent evolution in banking. The banking framework homogenized, leaving little room for variation in institutional or regulatory design.¹⁸ As a result, banks operating outside of the dominant banking model struggled to survive.

The market's answer to banking for the poor—fringe banking—is unacceptable. What we have today are two forms of banks—regulated mainstream banks that seek maximum profit for their shareholders by serving the needs of the wealthy and middle class, and unregulated fringe banks that seek maximum profits for their shareholders by taking advantage of the needs of the poor. What is missing from the American banking landscape for the first time in generations is a government-sponsored bank whose main purpose is to meet the needs of the poor. Rather than relegating the poor to fringe banks, policy makers must carve out a place for banks that serve the poor and enable them to survive and thrive. This charge has deep historic roots in U.S. banking.¹⁹

Since the inception of bank chartering in the United States until the last few decades, there existed an understanding that banks were “affected with a public interest.”²⁰ Chartered by the state and supported by the public fisc, they were

¹⁴ Edward L. Symons, Jr., *The United States Banking System*, 19 BROOK. J. INT'L L. 1, 11–12 (1993).

¹⁵ See *id.* at 15.

¹⁶ See, e.g., Robert W. Dixon, Note, *The Gramm-Leach-Bliley Financial Modernization Act: Why Reform in the Financial Services Industry Was Necessary and the Act's Projected Effects on Community Banking*, 49 DRAKE L. REV. 671, 680 (2001).

¹⁷ Lee B. David, Comment, *Banking—Mergers—Is Commercial Banking Still a Distinct Line of Commerce?*, 57 TUL. L. REV. 958, 970–79 (1983).

¹⁸ Fred E. Case, *Deregulation: Invitation to Disaster in the S&L Industry*, 59 FORDHAM L. REV. S93, S94 (1991); see also Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 FORDHAM L. REV. 501, 528–29, 533, 540 (1989).

¹⁹ See *infra* Part I.

²⁰ *Schaake v. Dolley*, 118 P. 80, 83 (Kan. 1911) (internal quotation marks omitted).

embodied with a “public nature.”²¹ It is this vision of banks as public trustees that has disappeared. Yet, banks are still in many ways state-sponsored and state-supported institutions.²² Banks still rely heavily on public subsidies and public bailouts, yet they have been relieved of their obligation to meet certain public needs.²³ To be clear, mainstream banks should not be forced to meet the needs of the poor. Nor should the needs of the poor be outsourced to them.

Turning to banking history for insight, this Article proposes a few options to meet the needs of the poor that go beyond merely regulating the current private institutions that are “serving” these individuals. First, the Article explores a few existing programs that can be redesigned in order to more adequately serve the needs of the poor. The Article examines the shortcomings of legislative efforts and self-help movements by the poor and illustrates how these efforts can be strengthened. The second proposal calls on the federal government to engage in a large-scale effort to provide low-cost credit to the poor using the Postal Service branch network. The Postal Service has been enlisted before in efforts to serve the poor, and it provides efficiencies due to economies of scale.²⁴ The Postal Service would offer check cashing and other routine and low-risk financial transactions to the poor at an interest rate that accurately reflects the risk of credit.

Part I of this Article describes the current landscape of low-income banking, and specifically why the poor need access to banks and the damaging alternatives that have taken the place of mainstream institutions in poor communities. Part II outlines the creation, development, and eventual demise of three institutions aimed at meeting the needs of the poor: the credit union, the S&L, and the Morris Bank. Part III then examines why these institutions have changed and why no alternatives have replaced them. The Article illuminates the larger political and social shifts as well as the resulting regulatory changes that have led banks away from serving communities and toward seeking higher profits. Part IV reviews the deficiencies in ongoing efforts to enlist mainstream banks in serving the poor, as well as legislation intended to remedy the problem of access without escaping the modern market model of banking. This Part then makes some specific recommendations that

²¹ *Id.*

²² See Joe Adler, *Frequently Asked Questions: Nationalize or Not? Hard to Define, Harder to Answer*, AM. BANKER (N.Y.), Feb. 20, 2009, at 1.

²³ *Id.*

²⁴ See *infra* Part IV.D.

are rooted outside the mainstream banking framework and allow alternative banking institutions to properly meet the needs of the poor.

I. BANKING FOR THE POOR: NEEDS AND BARRIERS

Policy makers have always recognized that access to financial services and credit is a significant step toward individual economic advancement.²⁵ Credit gives people the ability to absorb financial reversals, the means to start or expand a small business, and the capacity to build a financial safety cushion to withstand individual economic shocks.²⁶ Several studies have demonstrated that when poor communities are provided access to credit and other banking services, they thrive economically.²⁷ Studies show that small-scale credit leads to increased income and savings among borrowers.²⁸ It is also true that barriers to credit significantly hamper the economic development of poor communities and individuals.²⁹

Access to credit is an important means by which the poor can overcome poverty.³⁰ The poor need access to long-term credit such as student loans and

²⁵ See Barr, *supra* note 5, at 134–41 (listing consequences of not having access to mainstream financial services); Stacie Carney & William G. Gale, Asset Accumulation Among Low-Income Households 22–23 (Feb. 2000) (unpublished manuscript), available at <http://www.brookings.edu/views/papers/gale/19991130.pdf> (finding households without bank accounts 43% less likely to have positive holdings of net financial assets); Lawrence H. Summers, U.S. Sec’y of Treasury, Remarks Before the U.S. Conference of Mayors (Jan. 28, 2000), available at <http://www.treasury.gov/press-center/press-releases/Pages/ls356.aspx> (describing individual access to financial services, and specifically bank accounts as the “basic passport to the broader economy”).

²⁶ “Access to credit assures access to basic necessities for debtors who, because of un- or under-employment, lack an adequate income to pay for essentials like food, shelter, and medicine.” Regina Austin, *Of Predatory Lending and the Democratization of Credit: Preserving the Social Safety Net of Informality in Small-Loan Transactions*, 53 AM. U. L. REV. 1217, 1227 (2004).

²⁷ See ASLI DEMIRGÜÇ-KUNT ET AL., WORLD BANK, FINANCE FOR ALL?: POLICIES AND PITFALLS IN EXPANDING ACCESS 138 (2008) (concluding that “the bulk of the evidence suggests financial development and improved access to finance is likely not only to accelerate economic growth but also to reduce income inequality and poverty”); Barr, *supra* note 5, at 127; J. Wyatt Kendall, Note, *Microfinance in Rural China: Government Initiatives to Encourage Participation by Foreign and Domestic Financial Institutions*, 12 N.C. BANKING INST. 375, 377 (2008) (“Researchers have demonstrated that there is a strong, positive correlation between an individual’s access to traditional banking services and an individual’s well-being.”).

²⁸ DEMIRGÜÇ-KUNT ET AL., *supra* note 27, at 99; Lewis D. Solomon, *Microenterprise: Human Reconstruction in America’s Inner Cities*, 15 HARV. J.L. & PUB. POL’Y 191, 199 (1992).

²⁹ See Kendall, *supra* note 27, at 375 (“[P]eople with access to banking services live above the poverty line, whereas those without access to banking services live below the poverty line.”).

³⁰ “Access to credit” is too broad a statement to be empirically measurable. The World Bank and various economists have studied this question without conclusive results as to what type of access is desirable among the poor. Anjali Kumar et al., *Measuring Financial Access*, in BUILDING INCLUSIVE FINANCIAL SYSTEMS: A FRAMEWORK FOR FINANCIAL ACCESS 7, 14–30 (Michael S. Barr et al. eds., 2007). This Article will not delve into this nuanced discussion; rather, it will start with the assumption that the low-income have less access to

business loans, as well as short-term credit for daily and emergency needs that are not met by mainstream loan products. But being “banked” is not just about getting a loan; it is also about having a secure place to invest, building a credit history, and being able to avoid expensive fringe financial services.

The poor do not have a right to be banked and I am not proposing that they should. However, if barriers to credit slow economic growth for the poor—and research seems to indicate that they do—these barriers need to be examined. This Article suggests that there is a market failure in providing the poor with access to credit due to the perceived higher risk of these borrowers and discrimination. In addition, small loans are not as profitable as large loans, so profit-maximizing institutions are not incentivized to make these loans. Government-sponsored organizations operating under different profit structures, such as mutual ownership, previously existed to fill the gap created by these incentives, but they are no longer available to the low-income. This Article examines the causes of their absence and advocates a renewed government initiative in banking. Providing healthy credit to the poor requires fewer resources than many other poverty alleviation programs because the state is only providing a subsidy, if needed, in absorbing some of the risks in lending to higher risk individuals. In addition, banking is a sector that already receives subsidies from the federal government, but most of those subsidies flow to large banks and their customers. This Article advocates for a revival of the concept of democratization of credit or renewed efforts to make low-cost credit and access to banking available to all members of society.

credit than others and that the credit they are given is not as good as the types of financial products given to the middle and upper classes. Numerous studies of credit options for the poor support these assumptions. *See, e.g.*, Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 68–69 (2008) (explaining that the presence of payday loans and subprime mortgages in low-income neighborhoods is not surprising because they are designed to extend credit to borrowers who are denied access to traditional credit); Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. REV. 513, 517, 553 (2005) (noting the connection between lower wealth and less access to credit); Kelly D. Edmiston, *Could Restrictions on Payday Lending Hurt Consumers?*, ECON. REV., First Quarter 2011, at 63, 83, available at <http://www.kc.frb.org/publicat/econrev/pdf/11q1Edmiston.pdf> (showing that in the absence of payday lending consumers in low-income counties would have limited access to credit); Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561, 1571 (1995) (“[M]arket imperfections can leave creditworthy borrowers in low-income neighborhoods without access to credit or with less access than they would have if markets worked perfectly.”).

A. *The Costs of Fringe Banking on the Poor*

The rise of fringe banking correlates directly with the decline in accessibility to low-cost credit from government-sponsored banks, such as the credit union and S&L.³¹ Christopher Peterson has noted that since “[l]ow-to-moderate income consumers have lost access to banks and credit unions since the late seventies, [they] have naturally moved to [fringe lenders] for their financial needs.”³² Fringe banking has grown exponentially since the 1980s.³³ “There are more pawnshops today, both in absolute numbers and on a per capita basis, than at any time in United States history.”³⁴ Prior to the mid-1970s, check-cashing institutions existed in only a few urban areas, but throughout the 1980s, these institutions rapidly expanded throughout the country.³⁵ “Virtually nonexistent in this country 20 years ago, [this sector] has grown into a \$100 billion business. Since the mid-1990s, the number of payday lenders nationwide has grown over 10 percent annually.”³⁶

The fringe banks moved into neighborhoods vacated by banks, and in turn, the prevalence and market dominance of predatory lenders drove remaining mainstream banks out of many poor communities.³⁷ This trend has only accelerated in recent years as banks have increasingly closed branches in poor neighborhoods in order to maintain profitability.

Fringe banking operations such as loan sharks, pawn shops, payday lenders, and check-cashing stores operate at high costs to the poor.³⁸ Scholars repeatedly point out the danger of having the poor serviced by unregulated lenders and have proposed specific regulations to curtail the most egregious behaviors of some of these lenders.³⁹ There are three concerns with these alternative financial services: (1) the costs of these services “reduce take-home

³¹ CASKEY, *supra* note 4, at 7.

³² CHRISTOPHER L. PETERSON, TAMING THE SHARKS: TOWARDS A CURE FOR THE HIGH-COST CREDIT MARKET 21 (2004); *see also* Mann & Hawkins, *supra* note 6, at 857.

³³ CASKEY, *supra* note 4, at 1–2.

³⁴ *Id.* at 1.

³⁵ *Id.* at 1–2.

³⁶ Joe Mahon, *Tracking “Fringe Banking”*, FEDGAZETTE, Sept. 2008, at 18, available at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4030.

³⁷ Richard R.W. Brooks, Essay, *Credit Past Due*, 106 COLUM. L. REV. 994, 996 (2006).

³⁸ *See generally* Barr, *supra* note 5 (discussing the high costs of alternative financial services); Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and Its Challenge to Current Thinking About the Role of Usury Laws in Today’s Society*, 51 S.C. L. REV. 589 (2000) (same).

³⁹ *See, e.g.*, CASKEY, *supra* note 4, at 9–10; Barr, *supra* note 5.

pay”); (2) low-income households face barriers to saving without formal bank accounts; and (3) without a formal relationship with a financial institution it is difficult to establish a credit history.⁴⁰

Studies show that many low-income families carry a startling debt load to payday loan providers, often taking out loans from one fringe lender to pay off another.⁴¹ Once these customers enter the payday loan industry, it becomes a trap from which they cannot escape. The typical check-cashing outlet charges between 1.5% and 3.3% of a check’s face value.⁴² For a typical client—who earns approximately \$18,000 per year—this amounts to nearly \$500 annually.⁴³ For payday borrowers, total annual fees amount to nearly \$600, with a typical client taking out approximately eleven two-week loans per year, at an average loan amount of \$300.⁴⁴ The average interest rate charged is usually 500%, well above both state and federal usury limits.⁴⁵ Unfortunately such limits are easily evaded through loopholes that enable “charter renting,” whereby a payday lender forms a relationship with a federal bank and “the payday lender solicits, manages, and issues each loan, but ostensibly uses the federal bank’s funds in exchange for a per-loan fee.”⁴⁶ The alternative financial service industry’s success is due to its ability to take advantage of the federally sponsored banking system, and it has come at the expense of poor individuals, many of whom, ironically, do not have access to these same government subsidies and protections.

⁴⁰ Michael S. Barr, Essay, *An Inclusive, Progressive National Savings and Financial Services Policy*, 1 HARV. L. & POL’Y REV. 161, 164 (2007).

⁴¹ See PETERSON, *supra* note 32; Ronald J. Mann, *After the Great Recession: Regulating Financial Services for Low- and Middle-Income Communities*, 69 WASH. & LEE L. REV. 729, 746–47 (2012) (discussing the “debt trap” of payday borrowing and its underlying causes); Skiba, *supra* note 6, at 1027 (“Many states have now banned payday lending based on the assumption that it enables borrowing behavior that leads to costly cycles of debt”); see also Robert Mayer, *Loan Sharks, Interest-Rate Caps, and Deregulation*, 69 WASH. & LEE L. REV. 807, 818–19 (2012) (discussing the debt trap in the context of loan sharks).

⁴² Barr, *supra* note 5, at 146–47.

⁴³ *Id.* at 148; see also PETERSON, *supra* note 32, at 14 (“A government study indicates the average customer is usually a woman in her middle thirties earning just over \$24,000 a year. She usually rents her home and once she becomes a customer of a short-term loan company she usually remains a customer for at least six months.” (internal quotation marks omitted)).

⁴⁴ Barr, *supra* note 5, at 156–57.

⁴⁵ *Id.* at 154.

⁴⁶ PETERSON, *supra* note 32, at 12–13; see also Austin, *supra* note 26, at 1241 (describing bank and payday lender partnerships as specifically designed to take advantage of loopholes in banking law in part because banks are eager to have fee income). This trend, including “rent-a-charter” arrangements, has apparently survived the recent banking crisis, as banks and payday lenders continue to partner in payday lending to split the fees from such loans. See Christopher Konneker, Comment, *How the Poor Are Getting Poorer: The Proliferation of Payday Loans in Texas via State Charter Renting*, 14 SCHOLAR 489, 509–10 (2011).

Some scholars and industry observers defend this fee as a justifiable premium deducted by these institutions to take on higher risk clients.⁴⁷ However, this is not the whole story. Many of these fees are also associated with relatively low- or no-risk transactions—such as the cashing of checks paid by the federal government or payday loans for those with a stable income. The profit margins can be quite large for these transactions. It is certainly true, however, that it costs more to give credit to the low-income and a premium must be extracted in those cases. This Article suggests below that lending to the poor is not a high-profit business, but that it is a worthy policy objective and government subsidies might be used in this endeavor.

B. *Barriers to Banking for the Poor*

There are a variety of barriers that keep mainstream banks from serving the poor, the first of which is profitability. Poor individuals may need banks, but the reverse is certainly not true. Most bankers and scholars agree that “[p]roviding financial services to the poor is fundamentally unprofitable.”⁴⁸ Banks have struggled to offer small loans to the poor because of their higher credit risk and the narrower profit margin on small loans. Banks incur approximately the same costs when originating a loan regardless of the principal amount,⁴⁹ but they generate much greater returns from large loans. Moreover, mainstream commercial banks have an obligation to their shareholders to maximize profits and “should not be required to extend credit if sound judgment suggests undue risk.”⁵⁰ Thus, banks look up the financial

⁴⁷ See, e.g., Aaron Huckstep, *Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?*, 12 FORDHAM J. CORP. & FIN. L. 203, 230–31 (2007); Mark Flannery & Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?* 21 (FDIC Ctr. for Fin. Research, Working Paper No. 2005-09, 2005), available at http://www.fdic.gov/bank/analytical/cfr/2005/wp2005/CFRWP_2005-09_Flannery_Samolyk.pdf (finding that the high prices charged by payday lenders can be justified by their costs and high default losses); see also Drysdale & Keest, *supra* note 38, at 616 (“Each segment of the fringe credit market justifies its costs in part by its higher transaction costs and in part by the higher level of risk assumed to be associated with lending to fringe market borrowers.”).

⁴⁸ Sow Hup Chan, *An Exploratory Study of Using Micro-Credit to Encourage the Setting Up of Small Businesses in the Rural Sector of Malaysia*, 4 ASIAN BUS. & MGMT. 455, 456 (2005). But see David Malmquist et al., *The Economics of Low-Income Mortgage Lending*, 11 J. FIN. SERVICES RES. 169, 181–82 (1997) (noting that “low-income lending is no more and no less profitable than non-low-income lending”); Bruce G. Posner, *Behind the Boom in Microloans*, INC., Apr. 1994, at 114 (stating that “[b]anks didn’t think you could make money making small loans to businesses . . . [but] are now finding that . . . microloans can be profitable” (internal quotation marks omitted)).

⁴⁹ Solomon, *supra* note 28, at 192.

⁵⁰ Ivan Light & Michelle Pham, *Beyond Creditworthy: Microcredit and Informal Credit in the United States*, 3 J. DEVELOPMENTAL ENTREPRENEURSHIP 35, 37 (1998) (quoting Katharine L. Bradbury et al.,

ladder to attract funds from corporations, pension funds, and high-net-worth individuals, while unregulated fringe bankers meet the needs of the poor. This tendency has created two banking systems in America: a government-subsidized, mainstream banking system for the rich and an unregulated, alternative banking system for the poor.

C. *Discrimination and Redlining*

Discrimination and redlining also limit the poor's access to banks. Compounding the problems with profitability in serving the poor, studies show that there is discrimination in banking where loans are denied to creditworthy individuals simply due to their race.⁵¹ Because many of the unbanked and underbanked are also people of color, this has exacerbated their problem of access. Other studies show that minorities are also offered worse financial products than whites.⁵² Moreover, banks often engage in redlining, which refers to the practice of drawing a red line through certain neighborhoods and refusing to lend there due to historic poverty, racism, or lack of adequate collateral.⁵³ The Community Reinvestment Act (CRA), discussed below in Part IV, attempts to remedy these problems.⁵⁴

Some policy makers and scholars have given up trying to force banks to meet the needs of the poor, claiming that cost considerations prevent delivery of services in some markets.⁵⁵ Frustrated, some claim that "banks' potential for service improvement [to the poor] is modest even were they run by God's

Geographic Patterns of Mortgage Lending in Boston, 1982–1987, NEW ENG. ECON. REV., Sept.–Oct. 1989, at 3, 3).

⁵¹ See *id.* at 38 ("Results [from a Boston Federal Reserve Bank study] showed that blacks and Hispanics were 56% more likely than non-minorities to be denied a mortgage loan net of creditworthiness."); Michele L. Johnson, Casenote, *Your Loan Is Denied, but What About Your Lending Discrimination Suit?:* *Latimore v. Citibank Federal Savings Bank*, 151 F.3d 712 (7th Cir. 1998), 68 U. CIN. L. REV. 185, 192–94 (1999); see also Shahien Nasiripour, *Wells Fargo Target of Justice Department Probe; Agency Alleges Discriminatory Lending*, HUFFINGTON POST, http://www.huffingtonpost.com/2011/07/26/wells-fargo-justice-department-probe_n_910425.html (last updated Sept. 25, 2011, 6:12 AM). See generally Helen F. Ladd, *Evidence on Discrimination in Mortgage Lending*, J. ECON. PERSP., Spring 1998, at 41 (concluding that lending data made available through various legislation shows clear discrimination in mortgage lending against minorities); Natasha Lennard, *Did Wells Fargo Prey on Black Borrowers?*, SALON (July 27, 2011, 1:28 PM), http://www.salon.com/2011/07/27/wells_fargo_preyed_on_black_borrowers_lawsuit/.

⁵² Lennard, *supra* note 51; Nasiripour, *supra* note 51.

⁵³ Lan Cao, *Looking at Communities and Markets*, 74 NOTRE DAME L. REV. 841, 851 n.26 (1999).

⁵⁴ See *id.* at 852.

⁵⁵ See, e.g., Malmquist et al., *supra* note 48, at 181–82; Posner, *supra* note 48, at 114; cf. Barr, *supra* note 5, at 183 (discussing the perceived low profitability of banking the poor); Barr, *supra* note 30, at 528 (discussing the criticism that the "CRA forces banks to engage in unprofitable, risky lending").

angels.”⁵⁶ Banks do not have to be run by “God’s angels” to properly serve the poor—but they must be run in a different way than most banks are today.⁵⁷ Banking history shows a variety of examples of banks that successfully met the needs of the poor while operating outside the mainstream model.

D. The Facade of Informality

Even when banks remain geographically available, they are often out of reach. Due to various regulatory measures, mainstream banks require extensive documentation, such as utility bills, a driver’s license, and a Social Security number or alien documentation number, in order to open an account.⁵⁸ Providing this documentation can be a significant barrier to banking for many in contrast to the ease by which they can access funds from fringe banks. In addition, many of the American poor who are immigrants or uneducated often do not speak English, may be illiterate, or have significant information barriers to traditional banking structures.⁵⁹ There are also intangible barriers of class and culture. When the poor have been asked about using fringe banks rather than mainstream banks, many claim that they are “not comfortable” dealing with banks.⁶⁰

Thus, mainstream banking has abandoned poor areas by shutting down branches and also by failing to speak the financial language of the poor. Payday lending businesses operate behind a facade of informality. These lenders operate in cash, at all hours, on a short-term basis, in the direct vicinity of their customers, and usually in their language.⁶¹ This business model seems

⁵⁶ Light & Pham, *supra* note 50, at 39.

⁵⁷ *Id.*

⁵⁸ See Barr, *supra* note 5, at 184.

⁵⁹ See *id.* at 183–84 (describing the lack of financial education as a barrier to becoming banked for at least a segment of the low-income population); *Check Cashers: Moving from the Fringes to the Financial Mainstream*, COMMUNITIES & BANKING, Summer 1999, at 2, 9 (explaining that while banks may “offer information about their services in various languages, bank staff may not be fluent in an immigrant’s native language”); cf. Michael A. Satz, *How the Payday Predator Hides Among Us: The Predatory Nature of the Payday Loan Industry and Its Use of Consumer Arbitration to Further Discriminatory Lending Practices*, 20 TEMP. POL. & CIV. RTS. L. REV. 123, 149 (2010) (“The typical payday loan customer has a below-average education and may not even speak English.”).

⁶⁰ Barr, *supra* note 5, at 180 n.282 (internal quotation marks omitted) (“About 18% of unbanked respondents to surveys reported that they were not ‘comfortable’ dealing with banks.”); accord Arthur B. Kennickell et al., *Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances*, 86 FED. RES. BULL. 1, 9–11 (2000).

⁶¹ See Michael A. Stegman & Robert Faris, *Payday Lending: A Business Model That Encourages Chronic Borrowing*, 17 ECON. DEV. Q. 8, 13 (2003) (“Focus groups of low-income and ethnic consumers . . . identifi[y] five ways in which check cashers were superior to banks: (a) easier access to

to be in direct contrast to banks with their rigid hours, requirements, fees, and procedures. Surveys reveal that many low-income individuals feel “[s]nubbed” by mainstream financial institutions and are “more pride-conscious than price-conscious and are therefore susceptible to the appeal of the secondary sector’s ‘merchandising of respect.’”⁶²

Despite the informal facade, fringe banks are highly profitable corporations whose rigid practices come into play as soon as debts become due. These businesses resort to intimidation, harassment, and legal process in order to collect payments.⁶³ By mimicking informal markets, these fringe banks have convinced their customers that they are operating in the informal realm, but their debt collection practices are quite formal and inflexible. As one commentator observed about a Washington, D.C. check-cashing outlet, “The primitive hands-on processing and tawdry exterior of the outlets both exude welcome to poor customers and mask [the firm’s] close ties to and substantial financing from large corporations and big banks.”⁶⁴

E. Democratization of Credit?

The payday lending industry claims that it is serving the needs of the poor and promoting the democratization of credit.⁶⁵ However, this industry does not provide credit that is productive to poor individuals. The poor are often in greater debt after their interactions with payday lenders than before.⁶⁶ The industry, instead of being an aid to lift the poor out of poverty, buries them

immediate cash; (b) more accessible locations; (c) better service in the form of shorter lines, more tellers, more targeted product mix in a single location, convenient operating hours, and Spanish-speaking tellers; (d) more respectful, courteous treatment of customers; and (e) greater trustworthiness.”)

⁶² Austin, *supra* note 26, at 1249 (quoting ROBERT D. MANNING, *CREDIT CARD NATION: THE CONSEQUENCES OF AMERICA’S ADDICTION TO CREDIT* 202 (2000)).

⁶³ PETERSON, *supra* note 32, at 16.

⁶⁴ Brett Williams, *What’s Debt Got to Do with It?*, in *THE NEW POVERTY STUDIES: THE ETHNOGRAPHY OF POWER, POLITICS, AND IMPOVERISHED PEOPLE IN THE UNITED STATES* 79, 87 (Judith Goode & Jeff Maskovsky eds., 2001).

⁶⁵ See Jean Braucher, *Theories of Overindebtedness: Interaction of Structure and Culture*, 7 *THEORETICAL INQUIRIES* L. 323, 335 (2006) (noting payday lenders’ portrayal of their products as promoting the democratization of credit); Cathy Lesser Mansfield, *Predatory Mortgage Lending: Summary of Legislative and Regulatory Activity, Including Testimony on Subprime Mortgage Lending Before the House Banking Committee*, in *CONSUMER FINANCIAL SERVICES LITIGATION 2001*, at 9, 40 (PLI Corporate Law & Practice, Course Handbook Ser. No. B0-00ZV, 2001) (describing testimony before the House Banking Committee).

⁶⁶ See *supra* Part I.C and accompanying notes.

further in debt.⁶⁷ “[T]he true democratization of credit . . . should foster the enhanced well-being for the least well-off borrowers.”⁶⁸

What low-income individuals need are flexible, informal banks that operate in their neighborhoods and are able to communicate in both their spoken and cultural languages. It is not implausible to imagine a less harmful institution that could serve the poor in the same way as fringe banks by understanding and meeting their needs. A 2008 report describing the financial conditions of the poor in New York City stated that “[t]here is a fundamental mismatch between current financial product and service offerings and the needs of households in these communities,”⁶⁹ which is the primary reason banks are not reaching the unbanked.⁷⁰ The underbanked make up 28% of the U.S. population and continue to grow, and their primary need is short-term financing.⁷¹

As discussed below, when unique barriers to serving the poor have arisen in the past, specialized banking institutions created innovative products to meet those needs. In order to meet the needs of the poor today, institutions will need to overcome the documentation, language, and cultural barriers of the poor and operate in their neighborhoods. As discussed below, the government, through the vast branching network of the United States Postal Service, could potentially offer the true democratization of credit. Postal branches operate in every zip code and are both familiar and accessible to the poor. The government could launch a program to offer short-term, low-cost credit options through the Postal Service. Indeed, “[w]e live in a real-time economy. Banks have more than enough technological horsepower and data on consumer behavior patterns to cash paychecks with little to no risk.”⁷² The government could offer many—if not all—of the products that fringe banks currently offer at a lower cost.

⁶⁷ See *supra* Part I.C and accompanying notes.

⁶⁸ Austin, *supra* note 26, at 1257.

⁶⁹ OFFICE OF FIN. EMPOWERMENT, N.Y.C. DEP’T OF CONSUMER AFFAIRS, NEIGHBORHOOD FINANCIAL SERVICES STUDY: AN ANALYSIS OF SUPPLY AND DEMAND IN TWO NEW YORK CITY NEIGHBORHOODS 24 (2008), available at http://www.nyc.gov/html/ofe/downloads/pdf/NFS_Compiled.pdf.

⁷⁰ *Id.*

⁷¹ Jennifer Tescher, *Underbanked, Under Banks’ Radar*, AM. BANKER (N.Y.), Apr. 28, 2011, at 8 (noting that an “FDIC study showed that the nonbank products and services used most frequently by underbanked households are money orders (81%) and check cashing (30%)”).

⁷² *Id.*

II. WHEN THE POOR HAD BANKS

At the inception of banking in the United States, there was recognition that banks were an instrumental state entity and that they were to be used to benefit the “common people.”⁷³ Thus, state and national governments employed banks to further government objectives.⁷⁴ Many of the first state banks were chartered to meet the credit needs of farmers, planters, and mechanics who lacked access to the First Bank of the United States.⁷⁵

During the industrial era, the nation’s banks expanded, which resulted in an accumulation of power to those with access to bank funds and a growing discomfort for those without access.⁷⁶ During the nineteenth century, as American industrialists were getting richer and the economy was expanding with the help of bank financing, a growing number of poor Americans clamored to be included in the banking sector. During the 1800s, an organization that was first called the “Knights of Reliance” and later “the Farmers’ Alliance” was formed in Texas to oppose the concentration of banking in the East and the power of Wall Street.⁷⁷ This populist movement advocated farming cooperatives across the country that were not beholden to Eastern banks.⁷⁸ Cooperatives were mutually owned and controlled financial institutions in which poor farmers pooled their resources and supported each other’s ventures.⁷⁹

The Progressives embraced these alternative banks and advocated the democratization of credit, or the extension of credit, to the working poor.⁸⁰ In response to these political movements by the poor that intensified during the Progressive Era and the Great Depression, credit unions and the S&L were

⁷³ SUSAN HOFFMANN, POLITICS AND BANKING: IDEAS, PUBLIC POLICY, AND THE CREATION OF FINANCIAL INSTITUTIONS 43 (2001).

⁷⁴ *Id.* at 72.

⁷⁵ *Id.*

⁷⁶ See Robert L. Rabin, *Federal Regulation in Historical Perspective*, 38 STAN. L. REV. 1189, 1203–04 (1986).

⁷⁷ *Id.*; Donald A. Lash, *The Community Development Banking Act and the Evolution of Credit Allocation Policies*, 7 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 385, 386–87 (1998); see also JOHN D. HICKS, THE POPULIST REVOLT: A HISTORY OF THE FARMERS’ ALLIANCE AND THE PEOPLE’S PARTY 108–09 (1931).

⁷⁸ ROBERT GUTTMANN, HOW CREDIT-MONEY SHAPES THE ECONOMY: THE UNITED STATES IN A GLOBAL SYSTEM 68, 76–78 (1994); Rabin, *supra* note 76, at 1202–03 (describing the attempt of the Farmers’ Alliance to promote a cooperative effort and its eventual defeat at the hands of the powerful banking system).

⁷⁹ See HICKS, *supra* note 77, at 132–34.

⁸⁰ JAMES GRANT, MONEY OF THE MIND: BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN 76–110 (1992).

created.⁸¹ The farming cooperatives provided the model for the credit union industry.⁸²

In addition to these formal institutions, there were several other banking ventures aimed at helping poor individuals. The Provident Loan Society, established in 1894 with \$100,000 provided by the richest men in New York City,⁸³ was a charitable organization that aimed to “relieve distress through enlightened and liberal lending but also, through competition, to force lower margins on profit-making pawnbrokers.”⁸⁴ By 1919, it was making more loans than any domestic savings bank with a policy “first, to make small and costly loans and, only second, to make large and profitable ones. It made loans of as little as one dollar [that required minimal collateral].”⁸⁵ The fund’s humanity was in stark contrast to the pawnbrokers at the time, but due to the nature of the bank’s loans, “[t]he truly indigent, almost by definition, were excluded, as they had nothing to pawn.”⁸⁶

In 1873, President Grant’s Postmaster General proposed a government-sponsored savings program modeled after one started in Britain.⁸⁷ A few years later, President Taft responded to growing populist proposals to establish a government-backed savings system for recent immigrants and the poor.⁸⁸ The Postal Savings System enabled the poor to save money with the assurance of a government guarantee.⁸⁹ These savings accounts were created and geared to recent immigrants and the unbanked poor,⁹⁰ and they were widely successful—at the end of the first year, there was a total of \$20 million in deposits, “most of which had been coaxed out of hiding.”⁹¹ The Post Office Inspector, Carter Keene, declared in 1913 that the Postal Savings System was not meant to yield a profit:

Its aim is infinitely higher and more important. Its mission is to encourage thrift and economy among all classes of citizens. It stands

⁸¹ See 80 CONG. REC. 6753 (1936).

⁸² Lash, *supra* note 77, at 386–87.

⁸³ GRANT, *supra* note 80, at 77, 85.

⁸⁴ *Id.* at 85.

⁸⁵ *Id.*

⁸⁶ *Id.* at 87.

⁸⁷ *Id.*

⁸⁸ *Id.* at 87–88.

⁸⁹ *Id.* at 90; *Postal Savings System*, U.S. POSTAL SERVICE (July 2008), <http://about.usps.com/who-we-are/postal-history/postal-savings-system.pdf>.

⁹⁰ *Postal Savings System*, *supra* note 89.

⁹¹ GRANT, *supra* note 80, at 90.

for good citizenship and tends to diminish crime. It places savings facilities at the very doors of those living in remote sections, and it also affords opportunity for safeguarding the savings of thousands who have absolute confidence in the Government and will trust no other institution.⁹²

Throughout American history, there have been various state-supported attempts to meet the banking needs of the poor. The following sections outline the history of three banking institutions that were created for the poor and their eventual abandonment of their mission. Interestingly, all of these banks changed roughly at the same time—in the 1980s. The causes of this collective change in banking will be examined at length below. These banks shared several common traits: they were born of necessity to meet the needs of the poor, they formed special charters that were different from mainstream banks and were embraced by the law, they each drifted from their founding mission to serve the poor and started to compete with other banks, and they were each deregulated in order to compete with mainstream banks. None of these banks operated at a large profit, but that was not the point of their charters. Today, all of these banks maintain profit margins rivaling mainstream banks and are marketing their products to wealthy individuals.

A. *Credit Unions*

1. *Born of Necessity*

Credit unions started as a populist mechanism designed to empower farmers against bad loans that kept them indebted to bankers.⁹³ Farmers needed credit to run their businesses, but their source of credit was typically confined to traditional banks that were based in major cities like New York and Boston.⁹⁴ As the crop failures and financial woes of the 1920s took their toll on farms across the country, farmers quickly became heavily indebted to these outside banks and often lost their equipment, land, and livelihood.⁹⁵ This quickly led to a populist sentiment that resulted in farmers organizing a

⁹² *Id.*

⁹³ See Rabin, *supra* note 76, at 1203–04 (detailing the Farmers' Alliance plan to have the federal government issue credit for the farmers' crops to effectively eliminate private funding).

⁹⁴ *Id.*; see Lee J. Alston, Wayne A. Grove & David C. Wheelock, *Why Do Banks Fail? Evidence from the 1920s*, 31 *EXPLORATIONS IN ECON. HIST.* 409, 415–18 (1994); Julie Andersen Hill, *Bailouts and Credit Cycles: Fannie, Freddie, and the Farm Credit System*, 2010 *WIS. L. REV.* 1, 10–16.

⁹⁵ See Rabin, *supra* note 76, at 1202–03.

grassroots campaign to start credit unions.⁹⁶ Credit unions were envisioned as a way to cut out the middleman—commercial banks—and give farmers access to lower cost credit.⁹⁷

Thus, the proliferation of credit unions in the United States came in response to the Great Depression.⁹⁸ Previously, banks had made their services available mostly to corporations and wealthy individuals, disregarding lower income individuals.⁹⁹ This practice left underserved groups susceptible to exploitation. Loan companies would often charge up to the maximum interest rate allowed by law, while installment buying would exploit those in need of credit through “confusing rate schedules and discount schemes.”¹⁰⁰ Those unwilling or unable to navigate these legal alternatives to banks were forced to turn to loan sharks who would extract “up to a thousand percent” in interest rates.¹⁰¹ These high interest rates reduced purchasing power among the poorer classes, which in turn contributed to the economic malaise of the times.¹⁰²

Specifically, credit unions provided a method of lending in which farmers and rural populations were organized into credit groups.¹⁰³ Within these groups, those with excess money would make deposits from which the other local residents could receive loans.¹⁰⁴ The borrowers would then repay the

⁹⁶ See 80 CONG. REC. 6752 (1936).

⁹⁷ See Fred Galves, *The Discriminatory Impact of Traditional Lending Criteria: An Economic and Moral Critique*, 29 SETON HALL L. REV. 1467, 1479 n.18 (1999) (“Perhaps the most remarkable success story, however, was the credit union movement. Credit unions have been around since early in the century. They sprang from the . . . public spirited impulse . . . to facilitate the supply of consumer credit to workers, farmers, and other[s] . . . whose credit needs were not being adequately served by existing banking facilities.” (alterations in original) (quoting JONATHAN R. MACEY & GEOFFREY P. MILLER, *BANKING LAW AND REGULATION* 28–29 (2d ed. 1997))); Kelly Culp, Comment, *Banks v. Credit Unions: The Turf Struggle for Consumers*, 53 BUS. LAW. 193, 193–94 (1997).

⁹⁸ 80 CONG. REC. 6753 (1936) (showing that the number of credit unions grew from 257 in 1925 to 1,017 in 1930 and to 4,000 in 1935, and that credit union membership grew from 292,800 members in 1930 to 1,000,000 members in 1935).

⁹⁹ See *History of Credit Unions*, NAT’L CREDIT UNION ADMIN., <http://www.ncua.gov/about/history/Pages/CUHistory.aspx> (last visited Jan. 18, 2013).

¹⁰⁰ 80 CONG. REC. 6752 (1936); see also 78 CONG. REC. 7260 (1934) (comments of Sen. Sheppard). Senator Sheppard recounted the story of a man earning \$40 per week who undertook an installment purchase plan that required him to pay \$52 per week. *Id.*

¹⁰¹ 80 CONG. REC. 6752 (1936); see also 78 CONG. REC. 7260 (1934) (comments of Sen. Sheppard). Senator Sheppard recounted the story of “a railroad employee who borrowed \$30 from a loan shark, paid in interest \$1,080, and was then sued for the \$30. He paid 3,600 percent.” *Id.*

¹⁰² 78 CONG. REC. 7260 (1934) (comments of Sen. Sheppard).

¹⁰³ *Id.*; see also 80 CONG. REC. 6752 (1936).

¹⁰⁴ See 80 CONG. REC. 6752 (1936).

loans when they were financially able to do so.¹⁰⁵ Joining a group required recommendation from one's neighbors and entitled one to deposit, borrow, and vote on the operation of the bank under a "one-man one-vote" system.¹⁰⁶ Borrowers would receive loans "for productive or provident purposes upon security that the fellow credit unionists thought adequate."¹⁰⁷ Interest paid on loans was kept low, even though it was a credit union's sole source of income.¹⁰⁸

2. *An Innovative Response*

The early credit unions were able to overcome the high costs associated with lending to the poor, such as risk of delinquency, through group supervision. There was a requirement that there be a "common bond" among credit union members,¹⁰⁹ which was aimed at reducing the cost of credit and the chance of delinquency because members knew each other.¹¹⁰ By design, loan repayment was limited to two years, and the maximum interest rate chargeable was 1% per month.¹¹¹ The credit union's innovative response to high-cost credit was to use personal knowledge of an applicant as a proxy for the high interest usually used to offset the risk of lending to the low-income.¹¹²

The common bond requirement served several important purposes. Primarily, it was a substitute for the members' lack of credit history and

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* (internal quotation marks omitted).

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ 12 U.S.C. § 1759(b)(1)–(2) (2006); accord *Issues Currently Facing the Credit Union Industry: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Banking & Fin. Servs.*, 105th Cong. 12 (1997) [hereinafter *D'Amours Statement*] (statement of Norman E. D'Amours, Chairman, National Credit Union Administration).

¹¹⁰ Jonathan R. Siegel, *Zone of Interests*, 92 GEO. L.J. 317, 333 (2004); see also *First Nat'l Bank v. Nat'l Credit Union Admin.*, 863 F. Supp. 9, 10 (D.D.C. 1994) ("The original purpose behind the common bond provision was twofold: to insure the financial stability of credit unions by providing a sense of cohesiveness among members and by enabling the members to establish a borrower's credit worthiness at minimum cost; and to promote the growth of credit unions because it was faster and easier to form a credit union with members who already had a common bond."), *rev'd sub nom.* *First Nat'l Bank & Trust Co. v. Nat'l Credit Union Admin.*, 90 F.3d 525 (D.C. Cir. 1996), *aff'd*, 522 U.S. 479 (1998); cf. 78 CONG. REC. 7259–60 (1934) (comments of Sen. Barkley and Sen. Sheppard).

¹¹¹ Federal Credit Union Act, ch. 750, § 7, 48 Stat. 1216, 1218 (1934).

¹¹² See *First Nat'l Bank & Trust Co. v. Nat'l Credit Union Admin.*, 988 F.2d 1272, 1276 (D.C. Cir. 1993); Siegel, *supra* note 110, at 333; see also 78 CONG. REC. 7259–60 (1934) (comments of Sen. Barkley and Sen. Sheppard); *History of Credit Unions*, *supra* note 99.

collateral that traditional banks required to issue loans.¹¹³ Congress intended the common bond among the members of a credit union to create “a cohesive association in which the members are known by the officers and by each other in order to ‘ensure both that those making lending decisions would know more about applicants and that borrowers would be more reluctant to default.’”¹¹⁴ Such a cohesive association theoretically allowed “credit unions, unlike banks, [to] ‘loan on character.’”¹¹⁵ The common bond made federal credit unions distinctly tailored to serve the needs of lower income individuals.

3. *Embraced by the Law*

These initial credit unions later served as the catalyst for the Massachusetts Credit Union Act of 1909,¹¹⁶ the first state credit union act, which later served as the basis for the Federal Credit Union Act.¹¹⁷ The majority of states passed laws supporting the establishment of credit unions during the first three decades of the twentieth century.¹¹⁸ Congress passed the Federal Credit Union Act (FCUA) in 1934,¹¹⁹ stating that the Act addressed a “great national problem”¹²⁰ and noting the “very extraordinary” and “highly successful”

¹¹³ See *First Nat'l Bank*, 863 F. Supp. at 10 (“The original purpose behind the common bond provision was twofold: to insure the financial stability of credit unions by providing a sense of cohesiveness among members and by enabling the members to establish a borrower’s credit worthiness at minimum cost; and to promote the growth of credit unions because it was faster and easier to form a credit union with members who already had a common bond.”); cf. *First Nat'l Bank & Trust Co.*, 988 F.2d at 1275 (“[T]he very notion [that Congress intended the common bond requirement to protect banks against competition from credit unions] seems anomalous because Congress’ general purpose was to encourage the proliferation of credit unions, which were expected to provide service to those would-be customers that banks disdained.”).

¹¹⁴ *First Nat'l Bank & Trust Co. v. Nat'l Credit Union Admin.*, 90 F.3d 525, 529–30 (D.C. Cir. 1996) (quoting *First Nat'l Bank & Trust Co.*, 988 F.2d at 1276), *aff'd*, 522 U.S. 479 (1998); cf. *D'Amours Statement*, *supra* note 109, at 12 (“[The] common bond [requirement] then was an organization mechanism for credit unions and an early standard of safety and soundness. It was never the defining characteristic of credit unions.”).

¹¹⁵ *First Nat'l Bank & Trust Co.*, 988 F.2d at 1276 (quoting 78 CONG. REC. 12,223 (1934) (comments of Rep. Steagall)).

¹¹⁶ Massachusetts Credit Union Act of 1909, ch. 419, 1909 Mass. Acts 392.

¹¹⁷ 78 CONG. REC. 7259 (1934); see also *id.* at 12,224 (comments of Rep. Blanchard) (noting that “Massachusetts and other States have excellent laws on credit unions”).

¹¹⁸ *Id.* at 7260 (comments of Sen. Sheppard) (noting that only ten states did not have credit-union laws by this point).

¹¹⁹ Federal Credit Union Act, ch. 750, 48 Stat. 1216 (1934) (codified as amended in scattered sections of 12 U.S.C.).

¹²⁰ 78 CONG. REC. 7259 (1934) (comments of Sen. Sheppard).

record of credit unions in addressing the “legitimate credit” needs of “the poorer and working classes” throughout the Great Depression.¹²¹

As originally passed, the FCUA required that credit union members elect management, with each member having one vote¹²² as well as the ability to purchase shares and receive loans.¹²³ Membership in a credit union was “limited to groups having a common bond of occupation, or association, or to groups within a well-defined neighborhood, community, or rural district.”¹²⁴ While initially subject to taxation just like other banking institutions,¹²⁵ concern arose that subjecting credit unions to the same taxation as commercial banks would place “a disproportionate and excessive burden on the credit unions.”¹²⁶ Responding to this concern, Congress, three years after initially passing the FCUA, amended the statute by extending significant tax exemptions to credit unions.¹²⁷

The tax exemptions were a critical government subsidy that allowed credit unions to continue to provide low-cost services. As a result of these provisions, the credit union industry grew dramatically after the Great Depression.¹²⁸ Specifically, from 1945 to 1966 the number of credit unions grew from 8,683 holding \$435 million in funds, to more than 23,000 holding in excess of \$11.5 billion in funds.¹²⁹ Additionally, these federally chartered credit unions were

¹²¹ *Id.* at 7259–61 (noting that credit unions “came through the depression practically without runs or failures”).

¹²² Federal Credit Union Act §§ 10, 11(b).

¹²³ *Id.* § 7(6)–(7).

¹²⁴ *Id.* § 9.

¹²⁵ *Id.* § 18.

¹²⁶ 82 CONG. REC. 358 (1937) (statement of Rep. Steagall).

¹²⁷ Federal Credit Union Act Amendments, ch. 3, 51 Stat. 4, 4 (1937) (amending section 18 of the Federal Credit Union Act). Results from some recent studies suggest that traditional banking institutions would need to earn 40% more than a credit union to achieve the same level of retained earnings due to the tax exemption. *See* Donald Novajovsky, Note, *From National Credit Union Administration v. First National Bank & Trust to the Revised Federal Credit Union Act: The Debate over Membership Requirements in the Credit Union Industry*, 44 N.Y.L. SCH. L. REV. 221, 227 (2000). This was the first of a series of alterations to the federal credit union structure dealing with safety and soundness. In 1970, Congress created the National Credit Union Share Insurance Fund, a deposit insurance backed by the Treasury, analogous to the FDIC. *See* Act of Oct. 19, 1970, Pub. L. No. 91-468, § 203(a), 84 Stat. 994, 999–1000 (codified as amended at 12 U.S.C. § 1783 (2006)). In 1998, as part of the Credit Union Membership Access Act, Congress imposed heightened risk-based capital requirements on credit unions. *See* Credit Union Membership Access Act, Pub. L. No. 105-219, § 301(a), 112 Stat. 913, 923–31 (1998) (codified as amended at 12 U.S.C. § 1790d (2006)); 12 C.F.R. § 702 (1998).

¹²⁸ *See* Novajovsky, *supra* note 127, at 224 (citing HERMAN E. KROOSS & MARTIN R. BLYN, A HISTORY OF FINANCIAL INTERMEDIARIES 241–42 (1971)). In 1930, there were 1,100 credit unions in the United States; by 1960 there were over 10,000. *History of Credit Unions*, *supra* note 99.

¹²⁹ *See* Novajovsky, *supra* note 127, at 224 (citing KROOSS & BLYN, *supra* note 128, at 241–42).

indeed serving the underserved, working-class families that needed credit to expand and succeed.¹³⁰

4. *Credit Unions Drift from Their Initial Mission*

Credit unions slowly began to shift from being a resource for poor Americans to competing with other banks for the business of the middle class. Credit unions were caught up in the broader changes in banking and faced internal as well as external pressure to compete with other banks and seek higher profits. Credit unions started losing customers to unregulated entities due to their regulatory burdens, such as the common bond requirement and the interest rate limitations—the very things that enabled them to serve the poor.¹³¹ These forces created pressure on the credit union industry to seek deregulation and offer more attractive interest rates to its customers who had a growing number of investment options.¹³²

In 1970, the industry sought to completely overhaul its charter and adopt less restrictive requirements, leading Congress to amend the FCUA.¹³³ Thus, credit unions started to focus on attracting more customers and expanding the industry in order to stay viable among the different banking alternatives. The process of expansion and deregulation led to a change of mission. Credit unions were no longer about poverty alleviation; they were now a desirable alternative for middle-class investment.

¹³⁰ William R. Emmons & Frank A. Schmid, *Credit Unions and the Common Bond*, 81 REV. 41, 43 (1999) (“Historically, members of credit unions were drawn from groups that were underserved by traditional private financial institutions; these consumers tended to have below-average incomes or were otherwise not sought out by banks.”).

¹³¹ See *The Proposed Consumer Financial Protection Agency: Implications for Consumers and the FTC: Hearing Before the Subcomm. on Commerce, Trade, & Consumer Prot. of the H. Comm. on Energy & Commerce*, 111th Cong. 27 (2009) (statement of Michael Barr, Assistant Secretary for Financial Institutions, United States Treasury Department) (“Credit unions and community banks with straightforward credit products struggled to compete with less-scrupulous providers who appeared to offer a good deal and then pulled a switch on the consumer.”); Amanda Masset, Note, *The Evolution of the Common Bond in Occupational Credit Unions: How Close Must the Tie that Binds Be?*, 3 N.C. BANKING INST. 387, 399 (1999) (stating that credit unions are better able to compete with commercial banks after the enactment of the Credit Union Membership Access Act that expanded the number of people eligible to join a federal credit union).

¹³² HOFFMAN, *supra* note 73, at 204 (“[Americans’] savings—not worth banks’ bother in 1930—became the object of vigorous competition among banks, S&Ls, and, later, the new money market mutual funds.”).

¹³³ *Id.*

5. Deregulation

The mantra of banking regulation in the 1970s was increased competition,¹³⁴ and credit unions wanted to join.¹³⁵ They started offering market-oriented products to attract and keep customers.¹³⁶ However, their ability to compete was hampered by regulatory burdens, such as the common bond requirement, that kept them from freely courting customers. Eventually, the industry sought to relax the common bond requirement—its defining characteristic—to include multiple groups of people.¹³⁷

As credit unions shifted their focus to compete with banks for the funds of the middle class, a debate ensued over the common bond requirement, and the requirement came to represent the competitive advantage of banks vis-à-vis credit unions. As the economic recession of the late 1970s and early 1980s worsened, the National Credit Union Association (NCUA) undertook a reexamination of the common bond requirement.¹³⁸ In an effort to help credit unions compete with banks, the NCUA issued an interpretive statement stating that credit union memberships could include multiple occupational groups as long as each group had a common bond.¹³⁹ This dilution of the common bond requirement naturally led to increased credit union size, services, and competitive advantage.¹⁴⁰

¹³⁴ Clifford L. Fry & Donald R. House, *Economic Issues in the Defense of Directors and Officers of Financial Institutions*, 110 BANKING L.J. 542, 546 (1993).

¹³⁵ JAMES M. BICKLEY, CONG. RESEARCH SERV., NO. 97-548 E, SHOULD CREDIT UNIONS BE TAXED? 1, 7 (2005) (describing how the National Credit Union Association issued a series of administrative rulings that allowed multi-group federal credit unions and, consequently, allowed credit unions to be more competitive).

¹³⁶ *See id.*

¹³⁷ The National Credit Union Administration began this process in 1982 by issuing Interpretive Ruling and Policy Statement 82-1, Membership in Federal Credit Unions, 47 Fed. Reg. 16,775 (Apr. 20, 1982). It was later replaced by Interpretive Ruling and Policy Statement 82-3, Membership in Federal Credit Unions, 47 Fed. Reg. 26,808 (June 22, 1982), which further expanded the common bond requirement.

¹³⁸ Membership in Federal Credit Unions, 47 Fed. Reg. at 26,808.

¹³⁹ *Id.*

¹⁴⁰ After this expansive interpretation, the membership in credit unions increased by 30% from 1982 until 1998. Wendy Cassity, Note, *The Case for a Credit Union Community Reinvestment Act*, 100 COLUM. L. REV. 331, 331 n.1 (2000); *see also* Brief for Petitioners, Nat'l Credit Union Admin. v. First Nat'l Bank & Trust Co., 522 U.S. 479 (1998) (Nos. 96-843, 96-847), 1997 WL 245673, at *10. The number of credit unions grew fourfold from 1982 until the mid-1990s and combined to control nearly \$330 billion in funds from 70 million members. *See* Dean Foust, *Clipping the Wings of Credit Unions*, BLOOMBERGBUSINESSWEEK (Aug. 25, 1996), <http://www.businessweek.com/stories/1996-08-25/clipping-the-wings-of-credit-unions>. This growth has been primarily attributed to attracting customers from outside the typical common bond requirement. For example, nearly two-thirds of all the members in the AT&T Family Federal Credit Union do not work for AT&T and are considered outside of the company. *Id.*

The Supreme Court held, however, that the industry could not change its defining trait unilaterally.¹⁴¹ The Court struck down this broad interpretation of the common bond under a *Chevron* analysis in *National Credit Union Administration v. First National Bank & Trust Co.* in 1998.¹⁴² In swift response, the NCUA and the credit union industry began lobbying Congress for an amendment to the FCUA allowing for diversification. The NCUA's lobbying efforts focused on the preservation of the freedom of financial choice for Americans.¹⁴³ The freedom to choose credit unions over traditional banks gained some traction in Congress partly due to the fact that most credit union members were now in the middle class and credit unions had turned into a formidable lobby.¹⁴⁴

Six months after the Supreme Court's decision in *National Credit Union Administration*,¹⁴⁵ Congress passed the Credit Union Membership Access Act (CUMAA)¹⁴⁶ with near unanimous support to "ratify the longstanding policy of the [NCUA] with regard to [the] field of membership [in] Federal credit unions" by "specifically authoriz[ing] multiple common bond federal credit unions."¹⁴⁷ CUMAA was considered necessary to ensure that customers continued to have a broad array of choices in financial services.¹⁴⁸ One of the Act's most significant features was the exemption of credit unions from the Community Reinvestment Act (CRA), an Act aimed at providing banking

¹⁴¹ *First Nat'l Bank & Trust Co.*, 522 U.S. 479.

¹⁴² *Id.*

¹⁴³ *D'Amours Statement*, *supra* note 109, at 15–16.

¹⁴⁴ Cassity, *supra* note 140, at 344 ("Even before the Supreme Court decision was announced, . . . it was almost inevitable that . . . Congress would amend the FCUA . . . [T]he typical credit union member—educated, middle-class, mortgage-owning—is also the average voter." (footnote omitted)); *see also The Supreme Court's February 25, 1998 Decision Regarding the Credit Union Common Bond Requirement: Hearing Before the H. Comm. on Banking & Fin. Servs.*, 105th Cong. 15–16 (1998) (statement of Paul Kanjorski, Rep., H. Comm. on Banking & Fin. Servs.). Bankers still complain about the credit union lobby and its power. *See, e.g., Stacy Kaper, CUs' Deal on Mortgage Bill Irks Bankers*, AM. BANKER (N.Y.), Feb. 26, 2008, at 1.

¹⁴⁵ *See Eileen Canning, House Passes Credit Union Bill; Measure Headed for White House*, Bloomberg Banking Daily (BNA) (Aug. 5, 1998).

¹⁴⁶ Credit Union Membership Access Act, Pub. L. No. 105-219, 112 Stat. 913 (1998) (codified as amended in scattered sections of 12 U.S.C.).

¹⁴⁷ H.R. REP. NO. 105-472, at 1, 18 (1998); *see also* Cassity, *supra* note 140, at 345 n.92 (noting that the CUMAA passed 411–8 in the House and 96–2 in the Senate).

¹⁴⁸ *See Alex D. McElroy, Clinton Signs Credit Union Bill; NCUA to Begin Implementing Law Soon*, Bloomberg Banking Daily (BNA) (Aug. 11, 1998); *see also* Credit Union Membership Access Act §§ 1–2. Representative Vento also noted that "[b]y . . . allowing multiple common-bond credit unions, we are revamping and facilitating the federal credit union law and empowering credit unions to adapt to the 1990's market place." 144 CONG. REC. 18,730 (1998) (statement of Rep. Vento).

access to low-income individuals.¹⁴⁹ The exemption was a direct result of credit union lobbying.

Because of the seemingly rushed nature of the CUMAA,¹⁵⁰ there were many inconsistencies in the Act. Specifically, although Congress imposed numeric membership requirements that sought to limit the growth of multiple-common-bond credit unions, the limits were easily subverted and led to an increase in credit union membership.¹⁵¹ Moreover, Congress did not answer the glaring contradiction raised initially by the court of appeals regarding an expansive, multiple-common-bond interpretation, namely how unrelated members and groups can adequately determine and evaluate the creditworthiness of the additional members.¹⁵² The Act also did nothing to assuage the banking industry's fears that credit unions were acting essentially like banks without having to pay taxes or comport with the requirements of the CRA.

Today, credit unions are much like mainstream banks. The American Banking Association (ABA) has continually argued that credit unions are not fulfilling their mission to serve the underserved.¹⁵³ Buttressing the ABA's claim is a GAO report, which concluded that credit unions are more likely to serve middle and upper income people than lower income people.¹⁵⁴ Indeed, credit union expansion allowed them to compete with banks while enjoying

¹⁴⁹ See also Credit Union Membership Access Act § 203.

¹⁵⁰ See Cassity, *supra* note 140, at 345 n.91.

¹⁵¹ The current statute allows "fifty 3,000 member groups [to] come together . . . [with a] net growth to the institution [of] 150,000 members." However, the statute does not allow "three 50,000 member groups" for a net growth of 150,000. Because there are more smaller groups than larger groups it is likely that this will increase the membership in credit unions. Novajovsky, *supra* note 127, at 243.

¹⁵² First Nat'l Bank & Trust Co. v. Nat'l Credit Union Admin., 90 F.3d 525, 529–30 (D.C. Cir. 1996), *aff'd*, 522 U.S. 479 (1998); First Nat'l Bank & Trust Co. v. Nat'l Credit Union Admin., 988 F.2d 1272, 1276 (D.C. Cir. 1993).

¹⁵³ George Cleland, *Bank-like Credit Unions Should Face Bank-like Taxes*, ABA BANKING J., Jan. 1989, at 14 (explaining that the origin of the federal credit unions as self-help cooperatives with members sharing a common bond had been rejected for a more inclusive, profitable cooperative); Walter A. Dods, Jr., *This Is a Common Bond?*, ABA BANKING J., July 1997, at 17 (stating that "the typical credit union member is more likely to have above-average income and be college-educated and a homeowner—not low-income and underserved by banks").

¹⁵⁴ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-29, CREDIT UNIONS: GREATER TRANSPARENCY NEEDED ON WHO CREDIT UNIONS SERVE AND ON SENIOR EXECUTIVE COMPENSATION ARRANGEMENTS 5, 8 (2006) [hereinafter GAO, CREDIT UNIONS]. According to a 1996 study done by the Credit Union National Association (CUNA), credit union members had an average household income of \$43,480, whereas non-members had an average income of \$31,660—a difference of 37%. Culp, *supra* note 97, at 213. And according to the American Banking Association, "[C]redit union members have more years of education and are more likely to be employed full-time." *Id.* at 213 n.161.

advantageous tax and other regulatory and statutory exemptions, which taken together created an uneven playing field. Notably, some even claim that credit unions “come in and cherry-pick the most profitable [banking] business and then give nothing back to the community,”¹⁵⁵ a practice far from the original objectives of the Depression Era cooperatives.¹⁵⁶

6. *Community Development Credit Unions*

Despite the credit union industry’s general movement away from its original objectives, there still exist credit unions specifically designed to service low- and moderate-income groups and communities. One such organization, the National Federation of Community Development Credit Unions, was organized in the 1970s “to strengthen those credit unions that serve low-income, urban and rural communities.”¹⁵⁷ Credit unions with a focus on the poor call themselves “community development credit unions” (CDCU).¹⁵⁸ However, many of these credit unions have struggled to survive.¹⁵⁹

Despite their struggles to remain viable, some of these credit unions have proved at least somewhat successful in fulfilling their missions. One study of New York City’s Lower East Side People’s Federal Credit Union showed that the vast majority of the credit union’s borrowers were low-income minorities with little or no credit and no relationship with mainstream financial institutions.¹⁶⁰ Moreover, loans were small—\$1,700 on average—and for

¹⁵⁵ See Foust, *supra* note 140 (quoting Joe G. Howard, senior vice president at First National Bank & Trust Company in Asheboro, North Carolina).

¹⁵⁶ *Id.*

¹⁵⁷ *About Us*, NAT’L FED’N COMMUNITY DEV. CREDIT UNIONS, <http://www.natfed.org/i4a/pages/index.cfm?pageid=256> (last visited Jan. 18, 2013).

¹⁵⁸ *Id.*

¹⁵⁹ See Letter from Debbie Matz, Chairman, Nat’l Credit Union Admin., to Federally-Insured Credit Unions (Jan. 2010) [hereinafter NCUA Letter] (regarding the supervising of low-income credit unions and community development credit unions). Some estimates place the CDCU failure rate during the 1990s near 50%. Charles D. Tansey, *Community Development Credit Unions: An Emerging Player in Low Income Communities*, BROOKINGS INST. (Sept. 2001), http://www.brookings.edu/articles/2001/09/metropolitanpolicy_tansey.aspx. Statutory and regulatory efforts have been made to assist these credit unions in fulfilling their mission. See Lehn Benjamin et al., *Community Development Financial Institutions: Current Issues and Future Prospects*, 26 J. URB. AFF. 177, 178–79 (2004).

¹⁶⁰ See Tansey, *supra* note 159. Another study of Vermont’s Opportunity Credit Union showed that borrowers with little or no credit history were 30% less likely to receive auto loans from traditional banks as similarly situated individuals with some credit history. Jessica Holmes et al., *Does Relationship Lending Still Matter in the Consumer Banking Sector? Evidence from the Automobile Loan Market*, 88 SOC. SCI. Q. 585, 595 (2007). However, when seeking an auto loan from a CDCU, such borrowers suffered no significant disadvantage. *Id.* This, in large part, is due to the CDCU’s reliance on relationship lending. *Id.* This is significant because, as the authors explained, several studies show that relationship lending “can lower the cost

shorter terms, thus tailored specifically to meet the needs of the individuals the credit union served.¹⁶¹ The CDCU demonstrate that it is possible for credit unions to fulfill the mission that they were initially equipped to serve.

B. *Savings and Loans*

The S&L framework was built for the public purpose of increasing home ownership and savings among the poor.¹⁶² President Hoover believed that home ownership was intrinsically good for individuals and for society and pushed for the creation of a banking institution that could help the poor overcome the barriers to home ownership.¹⁶³ Originating in the United States prior to the Civil War, building and loan associations were set up “to help independent workingmen get suitable homes.”¹⁶⁴ The S&L framework combined the building and loan associations and savings banks, which were created in the nineteenth century to facilitate saving by the poor.¹⁶⁵ The S&Ls were labeled the “Workingman’s Way to Wealth” and lauded the “virtues of cooperation and emancipation from landlords.”¹⁶⁶

of financial capital and lessen credit rationing in the markets for small business loans and consumer loans.” *Id.* at 585 (citations omitted).

¹⁶¹ Marva E. Williams, *The Un-Banks: The Community Development Role of Alternative Depository Institutions*, in FINANCING LOW-INCOME COMMUNITIES: MODELS, OBSTACLES, AND FUTURE DIRECTIONS 159, 173 (Julia Sass Rubin ed., 2007) (summarizing other studies with similar findings).

¹⁶² See HOFFMANN, *supra* note 73, at 141.

¹⁶³ See DAVID L. MASON, FROM BUILDINGS AND LOANS TO BAIL-OUTS: A HISTORY OF THE AMERICAN SAVINGS AND LOAN INDUSTRY 1831–1995, at 78 (2004); see also Richard F. Babcock & Fred P. Bosselman, *Suburban Zoning and the Apartment Boom*, 111 U. PA. L. REV. 1040, 1046 n.50 (1963); Kenneth A. Stahl, *The Suburb as a Legal Concept: The Problem of Organization and the Fate of Municipalities in American Law*, 29 CARDOZO L. REV. 1193, 1253 (2008). President Hoover’s sentiment was not unique at the time. The California Supreme Court reasoned that:

With ownership comes stability, the welding together of family ties, and better attention to the rearing of children. With ownership comes increased interest in the promotion of public agencies, such as church and school, which have for their purpose a desired development of the moral and mental make-up of the citizenry of the country. With ownership of one’s home comes recognition of the individual’s responsibility for his share in the safe-guarding of the welfare of the community and increased pride in personal achievement which must come from personal participation in projects looking toward community betterment.

Miller v. Bd. of Pub. Works of L.A., 234 P. 381, 387 (Cal. 1925) (in bank).

¹⁶⁴ Lloyd Rodwin, *Studies in Middle Income Housing*, 30 SOC. FORCES 292, 293 (1952) (emphasis omitted); see also MASON, *supra* note 163, at 12.

¹⁶⁵ RICHARD SCOTT CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 12 (4th ed. 2009).

¹⁶⁶ Rodwin, *supra* note 164, at 293.

1. *Born of Necessity*

The need for these alternative sources of credit arose as a result of the collapse of the banking system in the South following the Civil War and the lack of banking services in the still-undeveloped West.¹⁶⁷ Most functioning banks available were in the Northeast and Midwest.¹⁶⁸ This lack of credit forced farmers in the South to turn to tenant farming, “borrowing from their landlord against their next year’s crop at exorbitant prices, . . . [while in] the West, they often managed without credit by living as subsistence farmers.”¹⁶⁹ Communities in these credit-starved areas addressed the lack of credit by creating institutions in which they pooled their money, from which those in need could receive loans to buy land, while those who had money could receive some return on their savings.¹⁷⁰

2. *An Innovative Response*

Much like credit unions, S&Ls were created as mutual savings banks.¹⁷¹ The model of the industry was neighbors helping neighbors.¹⁷² The first S&Ls were mutually owned.¹⁷³ They were created not to make profits, but to achieve the public purpose of building homes for their members.¹⁷⁴ These were distinctively not market entities—they were self-help institutions for the poor made possible by government subsidies and regulation.¹⁷⁵ Members also participated heavily in governance, much like in credit unions. S&L members elected the institution’s officers, who frequently were community leaders.¹⁷⁶

¹⁶⁷ Edward L. Rubin, *Communing with Disaster: What We Can Learn from the Jusen and the Savings and Loan Crises*, 29 LAW & POL’Y INT’L BUS. 79, 80–81 (1997).

¹⁶⁸ *Id.* at 80.

¹⁶⁹ *Id.* at 80–81.

¹⁷⁰ *Id.* at 81.

¹⁷¹ Nicole Fradette et al., *Project: Regulatory Reform: A Survey of the Impact of Reregulation and Deregulation on Selected Industries and Sectors*, 47 ADMIN. L. REV. 461, 645 (1995); Rubin, *supra* note 167, at 81.

¹⁷² See LAWRENCE V. CONWAY, AM. SAV. & LOAN INST., SAVINGS AND LOAN PRINCIPLES 254 (3d ed. 1965) (“[S]avings associations . . . try to be, and want you to think of us as, your friend and neighbor.”). Multiple S&Ls also use the phrase as a motto for their business or to describe the history of their establishment. See, e.g., *About Us—The Story*, ABBEVILLE SAVINGS & LOAN, <http://www.abbevillesavings.com/about.htm> (last visited Jan. 18, 2013); DALHART FED. SAVINGS & LOAN ASS’N, <http://www.dalhartfederal.com/> (last visited Jan. 18, 2013).

¹⁷³ HOFFMANN, *supra* note 73, at 155; MASON, *supra* note 163, at 17–18.

¹⁷⁴ See MASON, *supra* note 163, at 18; William F. McKenna, *Control and Management of Federal Savings and Loan Associations*, 27 S. CAL. L. REV. 47, 49 (1953).

¹⁷⁵ MASON, *supra* note 163, at 12.

¹⁷⁶ *Id.* at 21.

This pooling and lending of resources enabled home ownership for low-income people who were not given access to customary bank loans.¹⁷⁷ Soon, S&Ls were able to get bank loans to assist them in making larger loans to their members.¹⁷⁸

Savings and loans created innovative products to meet their members' unique needs. The S&L was initially responsible for creating loans that were accessible to average Americans. Their loans featured long-term amortization and high loan-to-value ratios (65%–75%).¹⁷⁹ These loans are familiar today, but it was the S&L that first created them.¹⁸⁰ Before the S&L, banks only provided home financing for 40%–60% loan-to-value ratios,¹⁸¹ with a term of one, three, or five years.¹⁸² Many people needed to get a second mortgage—through an unregulated lender at usurious rates—in order to finance their home.¹⁸³ Mainstream home financing was not within reach of most Americans, and there were no loans on older homes or low-value homes. S&Ls achieved great success¹⁸⁴ in providing low- and moderate-income Americans access to home ownership.¹⁸⁵ And they met this need by creating a product tailored to the needs of the poor.

3. *Embraced by the Law*

Savings and loans gained popularity because they met a growing need and desire of Americans. In 1930, there were over 12,000 S&Ls with more than

¹⁷⁷ *Michigan Tax on Bank Shares at Higher Rates Than on Savings and Loan Associations Does Not Violate Section 5219 of Revised Statutes*, 77 *BANKING L.J.* 588, 590–91 (1960); see also Rodwin, *supra* note 164, at 293.

¹⁷⁸ See MASON, *supra* note 163, at 78.

¹⁷⁹ *Id.* at 91, 162; cf. Allen F. Jung, *Terms on Conventional Mortgage Loans on Existing Houses*, 17 *J. FIN.* 432, 435 (1962) (discussing study showing that twenty-six of thirty-one surveyed S&Ls routinely offered mortgage loans with loan-to-value ratios of 60% or higher).

¹⁸⁰ See MASON, *supra* note 163, at 17–21 (describing various lending innovations, including a precursor to the amortizing mortgage, created by S&Ls to facilitate lending to individuals who did not have substantial savings).

¹⁸¹ See *id.* at 16, 91; cf. Jung, *supra* note 179, at 439–42.

¹⁸² MASON, *supra* note 163, at 16; Fradette et al., *supra* note 171, at 645.

¹⁸³ See LENDOL CALDER, *FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT* 65–66 (1999).

¹⁸⁴ See Kenneth A. Snowden, Jr., *The Anatomy of a Residential Mortgage Crisis: A Look Back to the 1930s*, in *THE PANIC OF 2008: CAUSES, CONSEQUENCES AND IMPLICATIONS FOR REFORM* 51, 58 (Lawrence E. Mitchell & Arthur E. Wilmarth, Jr. eds., 2010) (noting that the affordability of S&L mortgages resulted in the institutions holding a greater market share of one-to-four-family home mortgages “than life insurance companies, commercial banks and mutual savings banks combined”).

¹⁸⁵ See CALDER, *supra* note 183, at 66–67.

twelve million members and assets of more than \$8 billion.¹⁸⁶ During the Depression, S&Ls were susceptible to runs and in danger of being shut down. Banks called in the loans to S&Ls while their customers demanded their deposits.¹⁸⁷ Despite their struggles, many S&Ls survived the Depression intact because they did not hold demand deposits and were not obligated to pay their depositors right away.¹⁸⁸ In 1932, Congress, with President Hoover's backing, passed the Federal Home Loan Bank Act (FHLBA)¹⁸⁹ with the long-term goal of strengthening the S&Ls to provide home mortgages and increase home ownership.¹⁹⁰

After defeating President Hoover, President Roosevelt continued this vision for the S&L and enacted several pieces of legislation intended to help homeowners. The Home Owners' Loan Act of 1933 provided a federal charter to S&Ls and imposed federal control over them.¹⁹¹ Savings and loan members initially resisted because they wanted to preserve the "local" nature of the S&L and asked that their mission be written into the charter: S&Ls were to loan to customers within fifty miles of their office to build homes valued at \$20,000 or less.¹⁹²

Several times throughout the history of the S&L, the movement fizzled or risked being co-opted by business interests, but was saved by state and federal legislation aimed at preserving its purpose.¹⁹³ For example, when the FDIC started insuring banks in 1933,¹⁹⁴ deposits flowed out of S&Ls and into banks.¹⁹⁵ In 1934, S&Ls were given deposit insurance through the Federal

¹⁸⁶ Fradette et al., *supra* note 171, at 645.

¹⁸⁷ See Carl Felsenfeld, *The Savings and Loan Crisis*, 59 FORDHAM L. REV. S7, S8 (1991).

¹⁸⁸ MASON, *supra* note 163, at 77–78; see also Todd A. Caraway, Note, *The Standard of Review for Financial Institution Conservator and Receiver Appointments and Generally Accepted Accounting Principles: Franklin Savings Association v. Office of Thrift Supervision*, 10 J.L. & COM. 263, 266 (1991).

¹⁸⁹ Federal Home Loan Bank Act, ch. 522, 47 Stat. 725 (1932) (codified as amended in scattered sections of 12 U.S.C.).

¹⁹⁰ [1 AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S] DIV. OF RESEARCH & STATISTICS, FDIC, HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE 170 (1997) (noting that the FHLBA was the first statute in a series of legislation "driven by the public policy goal of encouraging home ownership").

¹⁹¹ Home Owners' Loan Act of 1933, ch. 64, 48 Stat. 128 (codified as amended in scattered sections of 12 U.S.C.).

¹⁹² HOFFMANN, *supra* note 73, at 172.

¹⁹³ Rodwin, *supra* note 164, at 293–94 (describing the threat to S&Ls and legislation introduced by the Massachusetts legislature to preserve their purpose).

¹⁹⁴ See Banking Act of 1933, ch. 89, 48 Stat. 162 (repealed 1999).

¹⁹⁵ See HOFFMANN, *supra* note 73, at 173.

Savings and Loan Insurance Corporation.¹⁹⁶ This made their continued existence viable by bringing them on par with mainstream banks.¹⁹⁷

In addition to having their own insurance fund, S&Ls also had their own regulators because they functioned differently from traditional banks.¹⁹⁸ “The mechanisms of the S&L framework were deliberately and elegantly engineered to channel social resources into home ownership, and they served their purpose effectively for forty-five years.”¹⁹⁹ S&Ls drew in the modest deposits of their members and channeled those into home mortgages for low-income families.²⁰⁰

4. *The S&L Drifts from Its Mission*

The S&L charters, which had grown increasingly popular over several decades, were slowly standardized and became an industry rather than a movement.²⁰¹ Nevertheless, S&Ls continued for decades to fulfill their progressive mission to provide housing for low-income Americans and continued to be mutually owned until the 1970s. However, the S&L industry failed disastrously in the late 1970s and 1980s for a variety of reasons, one of which is that it lost sight of its initial progressive purpose.²⁰² While there are a lot of hypotheses offered to explain the colossal failure of the S&L industry, it is undisputed that the industry changed its focus from serving low-income individuals to seeking higher profits by mimicking traditional banks.²⁰³

By the 1970s, mutual funds and money market accounts (MMAs) had become popular and were drawing deposits away from banks and S&Ls, who were capped in how much interest they could pay for deposits.²⁰⁴ Savings and

¹⁹⁶ LAWRENCE J. WHITE, *THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION* 54 (1991).

¹⁹⁷ *See id.*

¹⁹⁸ *See* HOFFMANN, *supra* note 73, at 158, 173.

¹⁹⁹ *Id.* at 177.

²⁰⁰ They also used resources of large investors. However, until 1958, the banks were over 95% funded by deposits. *See* HORACE RUSSELL, *SAVINGS AND LOAN ASSOCIATIONS* 31, 651 tbl.6 (2d ed. 1960).

²⁰¹ HOFFMANN, *supra* note 73, at 171, 178.

²⁰² *See* Felsenfeld, *supra* note 187, at S28–S29.

²⁰³ *Id.*

²⁰⁴ *Id.* at S20; *see also* Anita Ingrid Lotz, *Deregulation or Regulation: Money Market Mutual Funds and Other Illegitimate Offspring of the Banking and Securities Industry*, 1 ANN. REV. BANKING L. 187, 201 (1982) (discussing the “competitive threat” that money market accounts posed to depository institutions, and the “limited” ability of depository institutions to respond).

loans joined banks in arguing for the repeal of Regulation Q,²⁰⁵ the cap on interest rates.²⁰⁶ The cap on interest rates was ultimately repealed.²⁰⁷ But the repeal of the interest rate cap posed a problem for S&Ls, whose assets were primarily composed of long-term home loans that continued to pay interest at low rates.²⁰⁸ The sudden jump in rates S&Ls had to pay to attract deposits without a corresponding jump in rates being paid by their existing long-term borrowers meant that much more money was flowing out than in.²⁰⁹ S&Ls were caught in an interest rate squeeze.²¹⁰ Instead of supporting the mission of the S&L, policy makers responded by deregulating S&Ls and allowing them to engage in shorter term profit-making activities to bridge the profit and loss mismatch created by the sudden rise in market interest for deposits.²¹¹

Deregulation of S&Ls coupled with advances in banking that allowed money to move quickly between financial institutions caused S&Ls to abandon their missions. Soon, S&L members and the communities that had supported them for decades abandoned these changed entities. They did so for two reasons. First, the interest rate on deposits became more important because investors could now shop for the highest interest rate regardless of the location of the institution.²¹² The rate of return became more important than “buying local” for higher wealth individuals. Second, these changes diminished the importance of community and joint ownership. As the industry became more national and dispersed, communities and S&L members felt less of an obligation or a desire to invest with their local bank because they knew that with the S&L’s expanded powers, the funds could now be used internationally and would not necessarily be used to build their communities.²¹³ The national

²⁰⁵ Prohibition Against the Payment of Interest on Demand Deposits (Regulation Q), 12 C.F.R. § 217 (2011); *see also* MASON, *supra* note 163, at 190 (noting that “thrifts pushed regulators to let them offer innovative savings accounts capable of competing with investments earning market rates”).

²⁰⁶ Felsenfeld, *supra* note 187, at S20.

²⁰⁷ Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 1735f-7a(a)(2) (2006); *see also* Felsenfeld, *supra* note 187, at S20.

²⁰⁸ *See* Felsenfeld, *supra* note 187, at S20–S21.

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ STEPHEN PIZZO, MARY FRICKER & PAUL MUOLO, *INSIDE JOB: THE LOOTING OF AMERICA’S SAVINGS AND LOANS* 11 (1989); Felsenfeld, *supra* note 187, at S16.

²¹² *See* Gail Otsuka Ayabe, Comment, *The “Brokered Deposit” Regulation: A Response to the FDIC’s and FHLBB’s Efforts to Limit Deposit Insurance*, 33 UCLA L. REV. 594, 621 (1985) (arguing that “differences in interest rates” offered at different deposit institutions “reflect . . . a competition for deposits [because] [d]epositors seek to place their funds in the financial institution that offers the highest rates”).

²¹³ *See* MASON, *supra* note 163, at 241 (noting that efforts to rebuild public confidence in S&Ls after the crisis “involved emphasizing how thrifts were community organizations committed to serving local financial needs”).

marketplace commoditized the lending business. S&L customers became less aware of how their S&Ls were operated and became less resistant when S&Ls began to drift from their limited charters and engage in more mainstream banking activities.

5. Deregulation

In the early 1980s, the S&L industry underwent three phases of deregulation through the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), regulatory changes by the Bank Board, and the Garn-St Germain Act of 1982.²¹⁴ The DIDMCA repealed Regulation Q and broadened S&Ls' permissive activities.²¹⁵ Savings and loans could now offer credit cards and traditional interest-bearing checking accounts, as well as engage in commercial and general consumer lending.²¹⁶ They could also invest up to 20% of their assets in any combination of consumer loans, commercial paper, and corporate bonds, while commercial banks were still prohibited from investing in any type of securities.²¹⁷ The DIDMCA also increased Federal Savings and Loan Insurance Corporation (FSLIC) insurance from \$40,000 per account to \$100,000.²¹⁸

In 1983, the Federal Home Loan Bank Board further loosened regulations on S&Ls to allow them to invest in options and to buy and sell securities—both prohibited for commercial banks—and to offer variable-rate mortgages to shift some interest rate risk onto their customers.²¹⁹ Regulators also lifted a 5% cap on so-called “brokered deposits,” big bundles of accounts from pension funds, unions, or government agencies.²²⁰ Now, when an S&L needed an infusion of deposits, it could simply offer the highest interest rate for the day

²¹⁴ Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (codified as amended in scattered sections of 12 U.S.C.).

²¹⁵ Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in scattered sections of 12 U.S.C.); see also R. Alton Gilbert, *Requiem for Regulation Q: What It Did and Why It Passed Away*, FED. RES. BANK ST. LOUIS REV., Feb. 1986, at 22, 30–33, available at http://research.stlouisfed.org/publications/review/86/02/Requiem_Feb1986.pdf.

²¹⁶ Depository Institutions Deregulation and Monetary Control Act §§ 401, 402; see MASON, *supra* note 163, at 216 (noting that the DIDMCA allowed “S&Ls to offer charge cards and NOW accounts,” which are interest-bearing checking accounts).

²¹⁷ Depository Institutions Deregulation and Monetary Control Act § 401; Jeffrey W. Allister, *Federal Charter vs. State Charter: New Opportunities for Savings Banks*, 98 BANKING L.J. 908, 909 (1981).

²¹⁸ Depository Institutions Deregulation and Monetary Control Act § 308.

²¹⁹ Implementation of New Powers; Limitation on Loans to One Borrower, 48 Fed. Reg. 23,032, 23,061, 23,070 (May 23, 1983) (codified at 12 C.F.R. §§ 545.33, .75 (1984)).

²²⁰ PIZZO, FRICKER & MUOLO, *supra* note 211, at 19; *Key Federal Regulatory Changes for S&Ls*, BANKING POL'Y REP., Aug. 16, 1993, at 7.

and arrange for brokers to deposit virtually as much money as was needed or wanted.²²¹ Savings and loans were growing larger and, due to more relaxed accounting standards allowed by federal regulators, taking larger risks.²²²

In spite of these efforts to save the S&L industry, it continued to mount record losses throughout the early 1980s.²²³ Congress passed the Garn-St Germain Act in 1982 as another attempt to prop up the ailing industry.²²⁴ Under Garn-St Germain, Congress increased the proportion of non-home-related loans S&Ls could make,²²⁵ dropped the down payment requirement for home loans,²²⁶ and allowed S&Ls to be called “savings banks” rather than “savings and loans.”²²⁷ Through a joint resolution, Congress also placed the full faith and credit of the United States behind FSLIC insurance.²²⁸ At the same time, regulators loosened the regulations on who could own an S&L. Previously, an S&L was required to have at least 400 shareholders, with no one shareholder owning more than 25% of the stock.²²⁹ Now, a single shareholder could own an S&L.²³⁰

In addition to these measures, the Federal Home Loan Bank Board, the primary regulator of S&Ls, stopped enforcing many of its existing regulations.²³¹ Moreover, the number of regulators overseeing the industry was

²²¹ See Felsenfeld, *supra* note 187, at S31.

²²² *Id.* at S30–S34.

²²³ Robert J. Laughlin, Note, *Causes of the Savings and Loan Debacle*, 59 *FORDHAM L. REV.* S301, S310–S311 (1991).

²²⁴ *Id.* at S314.

²²⁵ Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 322, 96 Stat. 1469, 1499 (codified as amended at 12 U.S.C. § 1464 (2006)); Gillian Garcia et al., *The Garn-St Germain Depository Institutions Act of 1982*, *ECON. PERSP.*, Mar. 1983, at 3, 10–11; Jan S. Blaising, Note, *Are the Accountants Accountable? Auditor Liability in the Savings and Loan Crisis*, 25 *IND. L. REV.* 475, 480 (1991).

²²⁶ See Real Estate Lending Standards, 12 C.F.R. § 390.265 (2012).

²²⁷ Garn-St Germain Depository Institutions Act §§ 311, 325; Henry N. Pontell & Kitty Calavita, *White-Collar Crime in the Savings and Loan Scandal*, *ANNALS AM. ACAD. POL. & SOC. SCI.*, Jan. 1993, at 31, 34.

²²⁸ PIZZO, FRICKER & MUOLO, *supra* note 211, at 12; Edward J. Kane, *The High Cost of Incompletely Funding the FSLIC Shortage of Explicit Capital*, *J. ECON. PERSP.*, Fall 1989, at 31, 41.

²²⁹ PIZZO, FRICKER & MUOLO, *supra* note 211, at 12; Barbara Crutchfield George et al., *The Opaque and Under-Regulated Hedge Fund Industry: Victim or Culprit in the Subprime Mortgage Crisis?*, 5 *N.Y.U. J.L. & BUS.* 359, 383 (2009); Henry N. Pontell & Kitty Calavita, *The Savings and Loan Industry*, 18 *CRIME & JUST.* 203, 209–10 (1993).

²³⁰ PIZZO, FRICKER & MUOLO, *supra* note 211, at 12.

²³¹ George et al., *supra* note 229, at 381; see also *DIV. OF RESEARCH & STATISTICS*, *supra* note 190 (describing the internal shortcomings of the Federal Home Loan Bank Board, such as how the regulator was understaffed and underqualified to supervise the industry after passage of the DIDMCA and Garn-St Germain).

being reduced just as interest in owning and operating S&Ls was increasing.²³² Since S&L deposits were FSLIC-insured and backed by the full faith and credit of the United States, S&L owners could deal fast and loose with deposits without having to worry about repercussions from depositors. In reference to the S&L industry in the 1980s, Representative Jim Leach said, “What has developed . . . is a giveaway system where the potential profit has been privatized while the potential loss has been socialized”²³³ Thus, the industry became an attractive target for many unscrupulous investors and organizations. The loosened regulations attracted the interest of anyone who wanted access to millions of FSLIC-insured dollars without much fear of close scrutiny from regulators, including people with ties to the mafia and other organized crime.²³⁴

In 1987, President Reagan signed into law the Competitive Equality Banking Act (CEBA),²³⁵ which bailed out the S&L industry to the tune of \$10.8 billion.²³⁶ Even then, industry observers knew this was far less than what was necessary to save the industry.²³⁷ Many S&Ls continued to fail during the 1980s with a total loss to the federal government of over \$87 billion.²³⁸

These deregulatory measures were envisioned to help the ailing S&L industry recover its market strength by allowing them to compete more directly with commercial banks.²³⁹ The neoliberal ideal that dominated the era had little regard for the S&L’s unique mission and advocated for less government involvement and more freedom for S&Ls.²⁴⁰ This, it was thought, would save

²³² See DIV. OF RESEARCH & STATISTICS, *supra* note 190.

²³³ PIZZO, FRICKER & MUOLO, *supra* note 211, at 312.

²³⁴ See generally PIZZO, FRICKER & MUOLO, *supra* note 211 (detailing the stories of several unscrupulous owners of S&Ls who recklessly established complicated schemes to launder money from S&Ls with little fear of being caught by regulators); JAMES B. STEWART, *DEN OF THIEVES* (1991) (narrating the story of the key players in the insider trading and junk bond scandals of the 1980s, including how S&Ls were targeted as vehicles to finance these speculative investments).

²³⁵ Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (codified as amended in scattered sections of 12 U.S.C.).

²³⁶ *Id.* § 301(e)(1)(B).

²³⁷ See Arthur E. Wilmarth, Jr., *The Expansion of State Bank Powers, the Federal Response, and the Case for Preserving the Dual Banking System*, 58 *FORDHAM L. REV.* 1133, 1245–47 (1990) (attributing “the massive waive of failures that swept over the thrift industry” in part to Congress’s failure to pass a \$15 billion recapitalization plan).

²³⁸ U.S. GEN. ACCOUNTING OFFICE, *GAO/AIMD-96-123, FINANCIAL AUDIT: RESOLUTION TRUST CORPORATION’S 1995 AND 1994 FINANCIAL STATEMENTS 9–10* (1996) [hereinafter *GAO, FINANCIAL AUDIT*].

²³⁹ See KATHLEEN DAY, *S&L HELL: THE PEOPLE AND THE POLITICS BEHIND THE \$1 TRILLION SAVINGS AND LOAN SCANDAL* 100 (1993); Wilmarth, *supra* note 237, at 1143–44; see also Felsenfeld, *supra* note 187, at S33.

²⁴⁰ DAY, *supra* note 239, at 61.

the industry. This assumption led S&Ls to look more like commercial banks.²⁴¹ Although there is significant debate on the issue, many scholars have claimed that it was the deregulation of the industry that caused it to fail.²⁴²

The deregulation of the industry certainly contributed to its collapse, but it is also true that the S&L mission could not survive the 1980s atmosphere without serious political support and support by the S&L industry itself, neither of which existed. It is also the case that by the 1980s, home ownership was not the main financial obstacle of the poor because home financing was more accessible than at any other time.²⁴³

C. *Morris Banks and Industrial Loan Companies*

Morris Banks were a for-profit venture created to provide credit at low cost to low-income industrial workers. These banks were created by a financial innovation that enabled extending consumer credit without demanding collateral from the borrower.²⁴⁴ Morris Banks later became known as industrial loan companies (ILCs) or industrial banks (IBs).²⁴⁵

1. *Born of Necessity*

At the dawn of the twentieth century, there was a great need for small-scale and short-term credit among the poor and working classes.²⁴⁶ No one was meeting the short-term credit needs of the poor for four primary reasons: (1) usury laws prevented traditional lenders from extending credit at profitable

²⁴¹ *Id.*

²⁴² See, e.g., Felsenfeld, *supra* note 187, at S36 (“Inadequate activity on the part of both federal and state regulators is widely cited as a reason for the S&L crisis”); George et al., *supra* note 229, at 380–85; Mark David Wallace, Comment, *Life in the Boardroom After FIRREA: A Revisionist Approach to Corporate Governance in Insured Depository Institutions*, 46 U. MIAMI L. REV. 1187, 1253–63 (1992); Irvine Sprague, *Unrelated Series of Events Led to S&L Crisis*, AM. BANKER (N.Y.), May 3, 1989, at 4 (“[I]f we must point a finger, it would have to be directed toward the Reagan deregulation philosophy of ‘everything goes’ and ‘every man for himself.’”). Others have concluded that the mission of the S&L—to increase home ownership—was the cause of its failure because it did not allow them to diversify into different products when the real estate market suffered. Felsenfeld, *supra* note 187, at S48.

²⁴³ See CALDER, *supra* note 183, at 65–67.

²⁴⁴ See O. Emre Ergungor & James B. Thomson, Fed. Reserve Bank of Cleveland, *Industrial Loan Companies*, ECON. COMMENT. (Oct. 2006), available at <http://www.clevelandfed.org/research/commentary/2006/1001.pdf>.

²⁴⁵ See *id.* Industrial banks today are dramatically different from early Morris Banks and would have been a historical footnote were it not for the shifts in banking that made them the only banking charter that could be owned and controlled by a commercial bank. Today, these banks are referred to interchangeably as industrial loan companies or industrial banks.

²⁴⁶ See GRANT, *supra* note 80, at 76–110.

rates;²⁴⁷ (2) lenders were unable to distinguish between high- and low-risk borrowers who could not provide collateral, creating adverse selection problems;²⁴⁸ (3) public mores attached a stigma to both the client and the lender;²⁴⁹ and (4) bankers were of the opinion that consumer loans were not a market for banking.²⁵⁰

In 1910, Arthur Morris, a Virginia lawyer who first coined the phrase “democratization of credit,” felt a personal motivation to meet the credit needs of the poor. He had observed that low- to moderate-level income earners lacking the necessary collateral but with a consistent history of income were unable to obtain loans through conventional commercial banks and were instead forced to turn to pawnbrokers or loan sharks for their credit needs.²⁵¹ Morris desired to correct this “weak spot” in the banking system and combed the existing laws in search of a solution “that would correct the existing evils and supply credit to the needy.”²⁵²

²⁴⁷ FRANKLIN W. RYAN, USURY AND USURY LAWS 5–6 (1924).

²⁴⁸ Ergungor & Thomson, *supra* note 244.

²⁴⁹ See, e.g., Paul Hamilton, Jr., “You’ve Changed—We’ve Changed—” and We Must Now Change Even More!, INDUS. BANKER, June–July 1971, at 7.

²⁵⁰ GRANT, *supra* note 80, at 76–77.

²⁵¹ *Inventory of the Papers of Arthur J. Morris: Biographical Sketch*, U. VA. L. SCH., <http://www.law.virginia.edu/main/Morris,+Arthur+J.> (last visited Jan. 19, 2013) [hereinafter *Biographical Sketch*].

²⁵² PETER W. HERZOG, THE MORRIS PLAN OF INDUSTRIAL BANKING 12–13 (1928). Testifying before Congress, Morris repeatedly explained his desire to supply credit to the poor and working classes. See *Control and Regulation of Bank Holding Companies: Hearings on H.R. 2674 Before the H. Comm. on Banking & Currency*, 84th Cong. 585 (1955) [hereinafter *Control and Regulation of Bank Holding Companies*] (statement of Arthur J. Morris, Chairman of the Board, Morris Plan Corporation of America) (“I began the first Morris Plan bank . . . for the sole purpose of making a start in the democratization of credit. By this I mean the making of loans to the individual who had no security to offer for bank credit. I was not long in discovering the fact that more than 80 percent of the American public had no access to credit of any kind except as they resorted to loan sharks or charitable institutions.”); *Providing for Control and Regulation of Bank Holding Companies: Hearings on S. 829 Before the S. Comm. on Banking & Currency*, 80th Cong. 98 (1947) (statement of Arthur J. Morris, Chairman of the Board, Morris Plan Corporation of America) (“[T]here was no person, firm, or corporation in this country prior to 1910 that [was] interested for 5 minutes in democratizing credit, and giving the honest wage earner any access to credit, regardless of his human necessities or his business opportunities or any other reason. . . . But I just made up my mind that these people deserved an access to monetary credit, and I started the first Morris Plan Bank in Norfolk, Va., in 1910, in which everybody in that community pretty near said I was something sick, lame, and disordered.”); *Rural Credits: Joint Hearings Before the Subcomms. of the Comms. on Banking & Currency of the S. & of the H.R. Charged with the Investigation of Rural Credits*, 63d Cong. 717 (1914) (statement of Arthur J. Morris) (“The Morris plan is intended to correct . . . the loan-shark evil in the cities, and the present existing misapprehension that prevails in the minds of the laboring classes with respect to capital. One of its fundamental purposes is to teach the laboring classes of this country habits of frugality, the value of systematized thrift, . . . [and it] was intended to be to the wage earner what the national banks are to the men of commerce.”).

2. *An Innovative Solution*

Arthur Morris was motivated to meet this need and was innovative in his approach. Morris, who was convinced that “80 percent of the American public was being denied adequate banking services,”²⁵³ designed a system whereby loans to the poor were made based on three principles: (1) “[c]haracter, plus earning power, is a proper basis of credit”; (2) “[l]oans made on this basis of credit must carry the privilege of repayment over a period long enough to match the [borrower’s earning power]”; and (3) “[m]oney so borrowed should always be for some constructive and useful purpose.”²⁵⁴ From these principles, Morris developed a system that replaced collateral with the signatures of two cosigners, both of whom agreed to pay the loan should the borrower default.²⁵⁵ This innovation in lending is still used today.

By requiring cosigners to the loan, the “Morris Plan” resolved the adverse selection problem that had historically vexed lenders.²⁵⁶ However, by itself, the cosigner innovation would not have been sufficient for proper entrance into the personal loan market. The legal hurdle of usury laws also needed to be overcome; otherwise, the lender could not make any profit.²⁵⁷ Morris also solved this problem through a “dual plan,” involving two separate transactions.²⁵⁸ The plan resulted in a system that could stay within the letter of the usury law but still recoup the full cost of making relatively small, unsecured personal loans to unfamiliar borrowers.²⁵⁹ With his revolutionary new method of extending credit, Morris began establishing “Morris Plan” institutions in various cities around the United States,²⁶⁰ and by 1928 there were 106 such institutions.²⁶¹

²⁵³ GRANT, *supra* note 80, at 92.

²⁵⁴ HERZOG, *supra* note 252, at 17.

²⁵⁵ Ergungor & Thomson, *supra* note 244.

²⁵⁶ *Id.*

²⁵⁷ See M. R. NEIFELD, NEIFELD’S MANUAL ON CONSUMER CREDIT 371 (1961). For a state-by-state list of statutory maximums extant near the time Morris started his business, see RYAN, *supra* note 247, at 26–31.

²⁵⁸ NEIFELD, *supra* note 257, at 371; see also Louis N. Robinson, *The Morris Plan*, 21 AM. ECON. REV. 222, 222–23 (1931).

²⁵⁹ See NEIFELD, *supra* note 257, at 371.

²⁶⁰ David Mushinski & Ronnie J. Phillips, *The Role of Morris Plan Lending Institutions in Expanding Consumer Microcredit in the United States*, in ENTREPRENEURSHIP IN EMERGING DOMESTIC MARKETS 121, 126 (Glenn Yago et al. eds., 2008).

²⁶¹ *Id.* at 127.

3. *Embraced by the Law*

While their expansion was swift, Morris Plan Banks encountered some difficulty in obtaining charters because of confusion about their exact nature. In response to Morris's original application for incorporation of his charter bank in Virginia, a member of the Virginia Corporation Commission responded by letter:

I have carefully considered your application for a charter for your hybrid and mongrel institution. Frankly, I don't know what it is. It isn't a savings bank; it isn't a state or national bank; it isn't a charity. It isn't anything I ever heard of before. Its principles seem sound however, and its purpose admirable. But the real reason that I am going to grant a charter is because I believe in you.²⁶²

The first Morris Plan Bank—the Fidelity Savings & Trust Company—was opened in Norfolk in 1910 with a state charter.²⁶³

Arthur Morris set out on a vigorous campaign to encourage enactment of laws that would enable the Morris Banks to fulfill their mission of lending to low-income workers.²⁶⁴ By 1930, Morris Plan Banks were operating in thirty-one states.²⁶⁵ In some states, specially tailored legislation was enacted to support Morris Banks; in other states, Morris Banks operated under the state banking or even general corporation laws.²⁶⁶ Thus, although united in name, the industry was divided in operations and, increasingly, in customer markets.²⁶⁷ It was along these fault lines that the industry split into those that would continue to fulfill Arthur Morris's vision of extending credit to the working class and those that pursued other clients for their business.²⁶⁸

²⁶² *Biographical Sketch*, *supra* note 251.

²⁶³ GRANT, *supra* note 80, at 92; *see also* Ralph N. Larson, *The Future of Installment Banking*, INDUS. BANKER, Aug. 1962, at 12.

²⁶⁴ *See* EVANS CLARK, FINANCING THE CONSUMER 69–70 (1930).

²⁶⁵ *See id.*

²⁶⁶ *See id.*

²⁶⁷ *See* CALDER, *supra* note 183, at 286.

²⁶⁸ *Id.*; *cf. A United Industry and One Strong Association*, INDUS. BANKER, June–July 1971, at 5. This last article announced the merger of the American Industrial Bankers Association (AIBA), publisher of the *Industrial Banker*, with the National Consumer Finance Association (NCFA). Significantly, the joined associations would maintain the name National Consumer Finance Association, while the AIBA would be subsumed as a section within the NCFA. Symbolic of the closeness that the personal finance industry (which had partially grown out of the entities regulated by the Uniform Small Loan Law) maintained with Morris's original consumer, the industrial worker, this last edition of the *Industrial Banker* ran an article entitled, *Mobile Home Financing*. *See* Leslie M. Jones, *Mobile Home Financing*, INDUS. BANKER, June–July 1971, at 9.

4. *Competition from Other Banks and Loss of Mission*

The principal reasons for Morris Banks converting to commercial banks were an increasingly competitive market,²⁶⁹ changes in the legal and regulatory environment that incentivized or required the switch,²⁷⁰ and tax advantages available to owners of commercial banks that were not available to industrial bank owners.²⁷¹ The primary driver of the Morris Banks' downfall as originally conceived was the competition for consumer loans. Because these banks were not mutually owned like credit unions and S&Ls, but instead made profits for their owners, their products were quickly copied by mainstream banks that also wanted to capitalize on these loans.²⁷² Expansion by commercial banks into consumer credit affected industrial banks most acutely "[s]ince commercial banks competed directly for Morris Plan clients, and could draw on much cheaper money."²⁷³

Commercial banks moved into consumer credit for a variety of reasons: lack of commercial loans during the Great Depression,²⁷⁴ a high demand for consumer credit,²⁷⁵ bankers' increased familiarity with and belief in the soundness of installment loans,²⁷⁶ and a change in the classification of intermediate- and long-term loans.²⁷⁷ With commercial banks entering into the personal loan market, Morris Banks found themselves needing to compete for their customers' dollars intensely and vigorously.²⁷⁸ Their strategy was twofold: expanding the types of loans they made and adopting commercial

²⁶⁹ RAYMOND J. SAULNIER, *INDUSTRIAL BANKING COMPANIES AND THEIR CREDIT PRACTICES* 30 (1940).

²⁷⁰ *Id.* at 54.

²⁷¹ *Id.* at 53.

²⁷² *Id.* at 169–71.

²⁷³ CALDER, *supra* note 183, at 361 n.70. "In both New York and in the rest of the country, loan volume and outstandings of industrial banks fell dramatically from 1931 to 1934. . . . By 1936, co-maker loans comprised less than 50 percent of total extensions of Morris Plan banks in New York State." DAVID H. ROGERS, *CONSUMER BANKING IN NEW YORK* 24–25 (1974) (footnote omitted). "Throughout the late 1930s, their average loan sizes were similar; and although the [industrial banks'] rates were somewhat higher than those of personal loan departments, the industrial bank was unquestionably a specialist in personal credit." *Id.* at 37.

²⁷⁴ CALDER, *supra* note 183, at 285.

²⁷⁵ NEIL H. JACOBY & RAYMOND J. SAULNIER, *BUSINESS FINANCE AND BANKING* 2–3 (1947).

²⁷⁶ *Id.* at 116–17.

²⁷⁷ *Id.* at 213.

²⁷⁸ ROGERS, *supra* note 273, at 37–38; *cf.* FRED H. CLARKSON ET AL., *CONSUMER CREDIT AND ITS USES* 33–34 (Charles O. Hardy ed., 1938) (listing eighteen different services the Morris Plan Industrial Bank of New York offered in 1938, which included Cunard-White Star Line Travel Loans, a plan to purchase furs, and a plan to finance memorials).

loan practices.²⁷⁹ By operating more like a commercial bank, Morris Banks found they could effectively compete.²⁸⁰ It was not much of a stretch for these institutions to go from operating like a commercial bank to converting into one, which is what happened with more and more regularity as the ILC grew further distant from its founding mission.

Although Morris Banks were attempting to democratize credit for low-income workers, they were a for-profit business from their creation.²⁸¹ However, the high costs associated with making small individual loans to those in desperate straits²⁸² made it difficult for these banks to retain their original mission after the founder, Arthur Morris, was no longer championing the cause.²⁸³ A statement by H. B. Jackson, secretary of the Morris Plan Company of New York, illustrates this shift: “While the remedial loan was the entering wedge of the Morris Plan and must always remain an important part of our work, it is to the constructive loan that we look with the greatest expectation of results.”²⁸⁴ While it may have been the wish of Arthur Morris to make the low-income wage earner the perpetual focus of Morris Bank loans, the movement away from this original mission was accelerated by the simple fact that, even from the very beginning, Morris Plan institutions were locally owned and operated and would respond to the demands of those local owners.²⁸⁵ This rapid shift demonstrates that profit-seeking ownership will always search out the most efficient use of capital for the desired appetite for risk. Morris Banks quickly abandoned their mission, and the legal and regulatory environment increasingly made commercial banks the attractive model for the ill-defined industrial bank.²⁸⁶

²⁷⁹ See CLARKSON ET AL., *supra* note 278, at 33–34.

²⁸⁰ NEIFELD, *supra* note 257, at 380 (“[T]he dual plan institutions have departed widely from the original ideal which was to limit such an institution’s facilities to the individual with modest credit requirements. They now serve business and professional people as well. They have come more and more to resemble commercial banks and to employ conventional bank lending techniques and types of loans.”).

²⁸¹ T. D. MacGregor, *Lending on Character Plus—the Modus Operandi of the Morris Plan Banks*, 103 BANKERS’ MAG. 863 (1921).

²⁸² NEIFELD, *supra* note 257, at 371; Ernst A. Dauer, *Radical Changes in Industrial Banks*, 25 HARV. BUS. REV. 609, 617 (1947).

²⁸³ See *Morris Plan Bankers Convention*, 105 BANKERS’ MAG. 924, 924 (1922) (detailing the assessment of Thomas Coughlin—the Morris Plan Bankers Association’s new president—regarding Morris Banks’ difficulties and the Banks’ new direction).

²⁸⁴ *Id.*

²⁸⁵ See *Control and Regulation of Bank Holding Companies*, *supra* note 252, at 578 (statement of Ellery C. Huntington, President, Morris Plan Corporation of America).

²⁸⁶ See *Morris Plan Bankers Convention*, *supra* note 283, at 924.

5. *Deregulation*

In the 1980s, commercial firms became interested in acquiring “nonbank banks,” or banks that were exempt from the Bank Holding Company Act (BHCA).²⁸⁷ Owning such a bank would allow commercial firms to enter banking without having to comply with the onerous regulations of the BHCA.²⁸⁸ The Competitive Equality Banking Act of 1987 closed the “nonbank bank[]” loophole,²⁸⁹ but specifically exempted ILCs because of a few well-placed senators whose states had a vested interest in chartering ILCs.²⁹⁰ The ILC loophole became one of the only and most attractive options for a commercial firm to own a bank.²⁹¹ Quickly after CEBA’s passage, large commercial firms, such as General Electric, General Motors, and American Express, started operating ILCs that they used to finance their own products.²⁹² The ILC sector grew exponentially.²⁹³ Today, there are no ILCs that operate like their early predecessors. Their early mission is just a curious historical note.

D. Common Features of Banks That Served the Poor

As Part II has shown, credit unions, S&Ls, and Morris Banks have several common features. First, these banks were born out of necessity. All three of these banks were used to meet the needs of the poor that were not being met by the banking institutions of the day. They were created outside of mainstream

²⁸⁷ U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-05-621, INDUSTRIAL LOAN CORPORATIONS: RECENT ASSET GROWTH AND COMMERCIAL INTEREST HIGHLIGHT DIFFERENCES IN REGULATORY AUTHORITY 17 (2005) [hereinafter GAO, INDUSTRIAL LOAN CORPORATIONS] (explaining that owning a bank exempt from the BHCA prior to CEBA would allow these banks to escape certain regulations).

²⁸⁸ *Id.*

²⁸⁹ *Id.* A letter from former Federal Reserve Board Chair Alan Greenspan to Congressman Jim Leach suggests that perhaps the reason CEBA exempted ILCs from the definition of *banks* was because at the time CEBA was enacted the number of ILCs was small, their total assets were small, and most states were not chartering or had a moratorium on chartering new ILCs. RANDALL DODD, FIN. POLICY FORUM, SPECIAL POLICY REPORT 13, INDUSTRIAL LOAN BANKS: REGULATORY LOOPHOLES AS BIG AS A WAL-MART 7–8 (2006), available at <http://www.financialpolicy.org/fpfspr13.pdf>.

²⁹⁰ DODD, *supra* note 289, at 7–8. The FDIC summarized it this way: “[I]n 1988, the first commercially owned ILC applied for FDIC insurance. Once the precedent had been set, more applications followed.” See Mindy West, *The FDIC’s Supervision of Industrial Loan Companies: A Historical Perspective*, SUPERVISORY INSIGHTS, Summer 2004, at 5, 9, available at <http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/sisum04.pdf>.

²⁹¹ DODD, *supra* note 289.

²⁹² *Id.*

²⁹³ Total assets grew from \$3.8 billion to over \$140 billion from 1987 to 2004. GAO, INDUSTRIAL LOAN CORPORATIONS, *supra* note 287, at 5.

banking and with a different vision than most banks. Second, they were all innovative in addressing the needs of the poor. The S&L helped create the modern mortgage, the Morris Bank created the non-collateralized loan, and the credit union created formalized lending cooperatives. The S&L and credit union were both community-owned and controlled and emphasized personal relationships with the borrower as a proxy for high interest. Third, each was supported by the government and regulated differently than mainstream banks. This governmental support was essential in the expansion of each of these banks and allowed them to thrive despite obstacles in servicing their clients. Fourth, all of these banks changed course dramatically in the 1980s and have abandoned their primary mission of providing credit to the poor. Fifth, deregulation played a key role in each bank's change of focus.

The following Part describes some of the general changes in banking and society that explain why low-income individuals have struggled with access to banks. These include changes in banking philosophy, including deregulation, as well as changes in the demographics of the poor and the changing nature of their needs. Drawing on successful features of the credit union, S&L, and Morris Bank, this Article then describes a few programs launched by the government, the poor, and non-profit organizations that may provide solutions to the problem of banking the poor.

III. WELCOME TO POTTERSVILLE

In Frank Capra's classic film *It's a Wonderful Life*, Mr. Potter, a heartless banker, tries to persuade George Bailey's building and loan association to stop providing home loans to the working poor. But George Bailey believes in the community building mission of his bank and starts up Bailey Park, an affordable housing project with the funds from his building and loan association. In contrast, Henry Potter envisions maximizing profits for his bank by driving out the poor and getting the most out of his bank's assets. In the movie, George Bailey triumphs with the help of an angel and a whole town's support. But in American banking history, Henry Potter's vision is the one that has more or less come to pass. The contrast between Bailey's and Potter's banks illustrates the difference between running a building and loan association that makes a profit, but has as its main objective servicing the working poor, and running a bank whose only aim is to maximize profits for its shareholders. Most mainstream banks today operate like Potter's bank.

This Part attempts to explain the sudden and dramatic shift in banking for the poor that occurred in the 1980s. Several specific factors caused the credit union, S&L, and Morris Bank to shift their focus away from the poor and toward mainstream banking customers, many of which have been outlined above. However, there are broader shifts in banking and in society that also explain this change, which is the focus of the following Part. Below, this Part discusses three generalized explanations of how the poor were cut out of banking: (1) market forces—such as changes in banking products, disintermediation, and financial innovation in the 1980s—that put pressure on the traditional banking model; (2) deregulation in banking; and (3) social and cultural explanations for the banking sector’s abandonment of the poor.

A. *Market Forces*

During the 1980s, mainstream banks that used to dominate the financial market started to lose market share to the capital markets and unregulated financial entities, such as investment banks, mutual funds, and hedge funds.²⁹⁴ Banks were no longer the only option for investors. The sophistication of the capital markets and new financial products allowed institutional and individual investors to access the markets without needing intermediaries. Disintermediation caused a streamlining in the movement of credit to the benefit of many businesses. At the same time, financial innovation provided customers a variety of investment options, and they quickly became comfortable depositing their money in money market accounts or mutual funds and removing it from their non-interest-bearing deposit accounts.²⁹⁵

Banks started to find ways around regulations in order to participate in the financial bounty of the 1980s. During this time, most banks left the “storage business”—originating and holding loans—and moved to the “moving business”—taking loans from originators, repackaging them, and moving them

²⁹⁴ See FDIC, MANDATE FOR CHANGE: RESTRUCTURING THE BANKING INDUSTRY 17–35 (1987) (discussing the declining market share of banks at the hands of unregulated financial innovations); Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1389–90 (1991) (noting banks’ struggles on both the asset and liability sides of the balance sheet).

²⁹⁵ CARL FELSENFELD, BANKING REGULATION IN THE UNITED STATES 47–48 (2004). Under these circumstances, bankers became increasingly resistant to government regulations that kept them from competing with non-banking entities and looked for ways to shed their regulatory chains. See Ebonya Washington, *The Impact of Banking and Fringe Banking Regulation on the Number of Unbanked Americans*, 41 J. HUM. RESOURCES 106, 111–12 (2006).

to secondary market investors like pension funds.²⁹⁶ Where banks used to make money on the spread—the difference between what they received from borrowers and the interest paid to depositors—banks now focused on fees for transactions.²⁹⁷ The easy profits from transactions distracted many banks from their core functions, and banks stopped lending to small- and medium-sized businesses in pursuit of ever-higher fees.²⁹⁸ Banks, which had operated a boring and safe business plan for many decades, became exciting, innovative, and much more profitable.

With the introduction of the money market account in the 1980s that paid high interest and allowed customers liquidity (the ability to write checks on the account), banks were forced to compete for large deposits and cut costs, including services previously offered to low-income customers.²⁹⁹ Both the S&L and the credit union were casualties of the increased competitive environment. Both of these banks joined the competition for deposits and were forced to shed unprofitable accounts in order to stay above water.³⁰⁰

The number of people with bank accounts declined starting in the 1980s, especially within the low-income sector,³⁰¹ due to “an increase in fees on deposit accounts with small balances.”³⁰² The GAO published an extensive report³⁰³ on these changes and prompted an additional study by the Federal Reserve that supported the finding that banks were indeed shedding low-income customers due to higher fees on checking accounts.³⁰⁴ Banks also began closing branches in low-income areas, leaving many low-income neighborhoods with no physical access to any banking institution.³⁰⁵ These branch closings especially impacted African-Americans and Hispanics living in urban areas.³⁰⁶ Once the banks left low-income communities, fringe banks moved in with staggering numbers.³⁰⁷

²⁹⁶ JOSEPH E. STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY 14 (2010).

²⁹⁷ *Id.* at 84.

²⁹⁸ *Id.* at 5–6.

²⁹⁹ CASKEY, *supra* note 4, at 88–89.

³⁰⁰ *See supra* Part II.A–B.

³⁰¹ *See* CASKEY, *supra* note 4, at 86. *See generally* BURHOUSE & OSAKI, *supra* note 3.

³⁰² CASKEY, *supra* note 4, at 87.

³⁰³ *See id.* at 86 n.3, 88–90.

³⁰⁴ *Id.*

³⁰⁵ *Id.* at 87, 90–91.

³⁰⁶ *Id.* at 94–95.

³⁰⁷ *See supra* Part I.C and accompanying notes.

During this time, banking also moved from focusing on a local market toward taking advantage of economies of scale and seeking a national presence. The impact on the poor from this change cannot be understated. In the age of conservative and boring banks, banks had a presence in a community and their assets and liabilities stayed within the community. This was the model of George Bailey's bank as well as the S&L and credit union. Funds would gather in a bank and stay there, which allowed the rich in the community to subsidize loans to the poor. As banking and banks became more complex in their operations, they also became more global and less local; money no longer had to stay in the community in which a depositor resided. If those assets could be used more efficiently in another market, they would move there—either through bank branching or banking affiliates. The advantage to this movement and complexity is the rate at which money could grow and make profits by being put to its most efficient use. Unfortunately, giving small loans to the poor at low interest is not an efficient way to grow money, and thus most banks stopped doing it.

B. Financial Deregulation

The rules of banking were changed to match the changed landscape. Banks lobbied vigorously for deregulation and for limited government intrusion into the banking market.³⁰⁸ The gradual deregulation of banks expanded from the Carter to the second Bush Administration.³⁰⁹ The banking sector thought that government regulation was stifling market competition and that they could operate more profitably and efficiently without it. Proponents of deregulation advocated a banking regime that was as close to a free market as possible.³¹⁰ There were many changes during this time, but most relevant here was the

³⁰⁸ Washington, *supra* note 295, at 111–12.

³⁰⁹ See Richard B. Freeman, *Reforming the United States' Economic Model After the Failure of Unfettered Financial Capitalism*, 85 CHI.-KENT L. REV. 685, 685–86 (2010) (discussing the development of banking deregulation throughout presidential administrations).

³¹⁰ See Troy S. Brown, *Legal Political Moral Hazard: Does the Dodd-Frank Act End Too Big to Fail?*, 3 ALA. C.R. & C.L. L. REV. 1, 8 (2012) (describing pro-market fundamentalism as “the basis for the incremental deregulation of the U.S. banking system”). See generally THOMAS F. CARGILL & GILLIAN G. GARCIA, FINANCIAL DEREGULATION AND MONETARY CONTROL: HISTORICAL PERSPECTIVE AND IMPACT OF THE 1980 ACT (1982). Cargill and Garcia argued that the problem with the structure of the financial system in the United States, beginning with reform legislation following the Great Depression through the 1970s, was that it constrained competition. *Id.* at 11–12.

homogenization of banking.³¹¹ As a result of the deregulation, most banks resembled each other in their mission and purpose.³¹²

The pluralism in banking was more or less abandoned and a more homogenized sector emerged. What this meant was that banks were all treated as market participants and forced to compete against each other for the same deposits and customers. The goals of the credit union and S&L were slowly lost and replaced by the demands of a competitive banking market. Many banks started to vigorously oppose the credit unions' favorable tax status as they started to compete more directly with banks.³¹³ Many believed that the banking market could meet the needs of the poor without these specially chartered institutions.³¹⁴ Indeed, some have even claimed that securitization was the market's answer to the home ownership goals of the S&Ls.³¹⁵ As a natural extension, increased securitization during the housing bubble should have been the ultimate fulfillment of the American dream rather than a major setback.

After the collapse of the financial markets, few people today would advocate for the deregulation that was pushed in the 1980s. Many policy makers recognize now that the recent banking collapse was at least partly caused by the no-holds-barred deregulation of the 1980s that allowed banks to become larger and more active in a variety of markets.³¹⁶ The Dodd-Frank Act

³¹¹ See James J. White, *Introduction to the Banking Law Symposium: A 200 Year Journey from Anarchy to Oligarchy*, 50 OHIO ST. L.J. 1059, 1063 (1989) (arguing that the Financial Institutions, Reform, Recovery and Enforcement Act of 1989 (FIRREA) would speed the "ultimate assimilation [of savings and loans] into commercial banks"); Daniel E. Feder, Comment, *Should Loan-to-Value Ratio Restrictions Be Reimposed on National Banks' Real Estate Lending Activities?*, 6 ANN. REV. BANKING L. 341, 344–54 (1987) (positing that a main goal of the Garn-St Germain Depository Institutions Act of 1982 was "to deregulate and homogenize the deposit-taking financial institutions market").

³¹² See White, *supra* note 311, at 1063; Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 476.

³¹³ Banks and policy makers fought against tax advantages and other special privileges for credit unions and S&Ls. See G. Allen Hicks, Comment, *Common Sense on the Common Bond: Banks, Federal Credit Unions, and Field of Membership Rules*, 66 TENN. L. REV. 1201, 1219–20 (1999).

³¹⁴ See, e.g., *id.* at 1207 (noting studies showing that banks made more mortgage loans to low-income individuals than credit unions).

³¹⁵ See Neil Fligstein & Adam Goldstein, *A Long Strange Trip: The State and Mortgage Securitization, 1968–2010*, in THE OXFORD HANDBOOK OF THE SOCIOLOGY OF FINANCE (forthcoming 2013) (manuscript at 10–11), available at http://www.history.ucsb.edu/projects/labor/documents/Fligstein_ALongStrangeTrip_UCSB.pdf.

³¹⁶ See, e.g., RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 45–46 (2009); Brian J.M. Quinn, *The Failure of Private Ordering and the Financial Crisis of*

of 2010³¹⁷ is, at least theoretically, a re-stiffening of banking regulation and a reasserting of regulatory control over banks.³¹⁸ However, as policy makers have begun to question some of the principles of deregulation, none have drawn attention to some of the important victims of deregulation: the banks that used to serve the poor.

C. *Social and Cultural Changes*

There are other possible explanations for why banking institutions stopped serving the poor that focus not on banks, but on the poor. These potential explanations can be summarized as follows: (1) banking institutions were victims of their own success—they graduated the poor into the middle class, solved the problem they were created to address, or are no longer needed to service the poor; and (2) the poor are now poorer than before and do not have sufficient funds to be banked.

1. *The Problem Was Solved*

This argument posits that when the S&L and credit union were created, the populace was much poorer than it is today. These institutions started in an era when there was more rampant poverty and less government support. It is indeed the case that American society has softened the blow of poverty since the Great Depression due to government safety nets; thus, there is more recourse for the destitute today than before. However, poverty remains and is increasing.³¹⁹ In September 2011, the Census Bureau reported that “the number of Americans living below the official poverty line, 46.2 million people, was the highest number in the 52 years the bureau has been publishing figures on it.”³²⁰ The report also warned of increased income inequality, wage stagnation, and rampant unemployment.³²¹ Poverty has always been, and continues to be, a reality for many Americans.

2008, 5 N.Y.U. J.L. & BUS. 549, 555–62 (2009) (arguing that a root cause of the financial crisis of 2008 was “financial innovation and the corresponding long-term move towards liberalization and self-regulation”).

³¹⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

³¹⁸ See *id.* § 312, 124 Stat. at 1521–23 (codified at 12 U.S.C. § 5412 (2006 & Supp. IV 2010)).

³¹⁹ Mark S. Littman, *Poverty in the 1980's: Are the Poor Getting Poorer?*, MONTHLY LAB. REV., June 1989, at 13, 13, 17; Hope Yen & Liz Sidoti, *Poverty Rate in U.S. Saw Record Increase in 2009: 1 in 7 Americans Are Poor*, HUFFINGTON POST (Sept. 12, 2010, 12:14 AM), http://www.huffingtonpost.com/2010/09/11/poverty-rate-in-us-saw-re_r_713387.html.

³²⁰ Sabrina Tavernise, *Poverty Rate Soars to Highest Level Since 1993*, N.Y. TIMES, Sept. 14, 2011, at A1.

³²¹ *Id.*

a. *The Poor Have Access to Credit*

Some claim that credit is abundantly available to the poor and that the problem they face is not that they are underserved by the credit industry, but overserved.³²² This argument relies on the widespread availability of fringe banking. However, as mentioned above, the fringe banking industry does not provide healthy credit options for the poor—credit that allows them to escape poverty. Aiding the poor is not about increasing the quantity of credit available. Rather, it is about improving the quality of available credit. The reason the credit union, S&L, and Morris Bank were successful in their missions is that they offered credit that was low cost and flexible.

Others claim that the poor need financial education in order to take advantage of smart credit, as opposed to high-cost credit.³²³ They claim that those who are poor are poor because they do not have the financial understanding of the middle class.³²⁴ Financial education is indeed necessary to overcome poverty. There are many factors that cause endemic poverty, and lack of education is an important contributor. Most low-income individuals know the difference between good credit and bad credit, but due to their economic status are only offered the latter. Many assume that the poor do not understand the financial system, and that they must be taught how it works.³²⁵ This is not necessarily the case. Many of the poor are balancing a variety of debts from different lenders, and juggling multiple payments with very few assets and resources.³²⁶ In many respects, they are better versed in the financial

³²² See generally GARY RIVLIN, *BROKE, USA: FROM PAWNSHOPS TO POVERTY, INC.—HOW THE WORKING POOR BECAME BIG BUSINESS* (2010) (discussing the variety of financial services offered by the multibillion-dollar fringe banking industry).

³²³ See MARIE FREDERICHs & ANDREA ROHRKE, FED. RESERVE BANK OF S.F., *GUIDE TO FINANCIAL LITERACY RESOURCES 1* (Lena Robinson ed., 2002), available at <http://www.frbsf.org/community/webresources/bankersguide.pdf> (“Consumers who understand the merits of responsibly managing their financial resources are more likely to effectively and profitably utilize the services of a traditional financial institution.”); *Getting It Right on the Money*, *ECONOMIST*, Apr. 5, 2008, at 73, 73 (stating “[t]hat many poor people do not have a bank account—and that few of them understand why this puts them at a disadvantage (let alone other essentials of personal finance)”).

³²⁴ FREDERICHs & ROHRKE, *supra* note 323, at 1 (“Financial literacy can also break the cycle of poverty, which is often associated with the unbanked.”); Annamaria Lusardi, *Financial Literacy: An Essential Tool for Informed Consumer Choice? 2* (June 2008) (unpublished manuscript), available at http://www.dartmouth.edu/~alusardi/Papers/Lusardi_Informed_Consumer.pdf (linking financial illiteracy to failure to plan for retirement, lack of participation in the stock market, and poor borrowing behavior).

³²⁵ See Light & Pham, *supra* note 50, at 37.

³²⁶ See Ignacio Mas & Mireya Almazan, *Viewpoint: Transaction-Based Model Best for Poor*, *AM. BANKER* (N.Y.), Nov. 5, 2010, at 9 (explaining how the poor require as much or more financial activity because of their volatile income and financial position).

system than many in the middle class because they are in daily contact with money, debt, and credit.³²⁷ Thus, it is not financial literacy that they most need, but institutional access that meets their specific needs.

2. *Too Poor to Bank*

The argument that the poor are too poor for bank accounts has some support in the historical data. John Caskey believed that lower income is the main cause for the decrease in bank accounts.³²⁸ In other words, apart from the changes in banking, people just do not have enough money to save anything at all. The poor are simply poorer now than they were in the past. Caskey identified several social changes that led to lower income for the poor, including the loss of low-skilled jobs, increased immigration, and an increase in single-parent homes.³²⁹ According to Caskey, lower income is one factor that led to the poor gradually moving away from mainstream banks and toward fringe lenders.³³⁰ This does not mean, however, that the poor do not need banks. They may not benefit from savings accounts, but as demonstrated above, they do need short-term credit.

IV. SOLUTIONS FOR BANKING TO THE POOR

A. *Enlisting Mainstream Banks*

Since the era of deregulation, government efforts to provide banking services to the poor have centered on mainstream banks. Policy makers have tried both carrot and stick measures in an attempt to get these banks to lend to the poor. Most of these initiatives have been unsuccessful.

1. *FDIC Pilot Program*

The most recent attempt by policy makers to induce mainstream banks to lend to the poor was launched in February 2008. The FDIC began the “Small-Dollar Loan Pilot Program,” a two-year campaign to enlist mainstream banks

³²⁷ *Id.* (explaining how the poor are often more experienced in the number of transactions they must undertake because of their changing income and financial position).

³²⁸ CASKEY, *supra* note 4, at 103, 105.

³²⁹ *Id.* at 100, 108.

³³⁰ *Id.* at 106 (“[T]he decline in account ownership mainly reflected a deterioration in the economic situation of households in the lower end of the income distribution.”).

to loan to the poor.³³¹ The project was described as “a case study designed to illustrate how banks can profitably offer affordable small-dollar loans as an alternative to high-cost credit products, such as payday loans and fee-based overdraft protection.”³³² The program enlisted twenty-eight volunteer banks to offer banking services that the poor needed, such as payday loans and check cashing.³³³

The Subcommittee on Financial Institutions and Credit of the House Committee on Financial Services met in September 2011 to review the program, and many were in agreement that the program had failed.³³⁴ Observers noted that banks were charging the maximum rates allowed in the program—36% APR and 20% charges on cashed checks.³³⁵ Some noted that these products were just like payday loans.³³⁶ Other congressmen resisted forcing mainstream banks to take on the risk of lending to the poor.³³⁷ Although the program resulted in some unbanked individuals forging new relationships with banks, the banks offered products that were not much more desirable than those offered by fringe banks, and the banks did not design new procedures or products that might be more attractive to the poor.

The main reason this program failed is that mainstream banks did not have the incentive to sacrifice profits in order to meet the needs of the poor. They must survive and stay profitable in a competitive banking market, and when they offer low-cost loans to the poor, they lose their competitive position and hurt their bottom line. The reason that the credit union, S&L, and Morris Bank were able to successfully reach the poor was because they were motivated to do so. In fact, that was their primary goal. Policy makers misunderstand the nature of mainstream banks if they are relying on them to adequately meet the needs of the poor. At best, they can be incentivized to do it in order to appease regulators. The products they offer are not innovative creations resulting from market research about what the poor really need—they offer the bare minimum

³³¹ *Small-Dollar Loan Pilot Program*, FED. DEPOSIT INS. CORP., <http://www.fdic.gov/small-dollarloans/> (last updated June 23, 2010).

³³² *Id.*

³³³ *Id.*

³³⁴ *The Availability of Credit Hearing*, *supra* note 2, at 9–10, 16–17.

³³⁵ *Id.* (statement of Robert W. Mooney, Deputy Director, Consumer Protection and Affairs).

³³⁶ *Id.*

³³⁷ *Id.* at 19, 24, 30 (comments of Rep. Luetkemeyer, Rep. Pearce, and Rep. Scott); *see also id.* at 44–45 (statement of Michael A. Grant, President, National Bankers Association).

so that they can maintain profitability while fulfilling a regulatory mandate.³³⁸ Forcing banks, whose purpose is to make maximum profits, to make loans to the poor will inevitably lead to inadequate loans and disgruntled bankers.

2. *Community Reinvestment Act*

Government efforts such as the Community Reinvestment Act attempt to remedy discriminatory behavior such as redlining, but they also encourage banks to lend in low-income communities.³³⁹ The CRA views the lending market through an affirmative-action framework and imposes duties on banks to lend to underserved communities.³⁴⁰ The CRA represents government imposition of social norms on the banking market and forces commercial banks to serve markets that they have deemed unprofitable.³⁴¹ As such, it has been controversial. Professors Macey and Miller have criticized the CRA by stating that it “promotes the concentration of assets in geographically nondiversified locations, encourages banks to make unprofitable and risky investment and product-line decisions, and penalizes banks that seek to reduce costs by consolidating services or closing or relocating branches.”³⁴²

Proponents of the CRA counter these claims by showing that the Act has indeed increased lending to low-income communities and led to more branch openings in these underserved areas.³⁴³ But most commentators agree that the enforcement of the CRA has been weak and has not brought about the desired results.³⁴⁴

³³⁸ Many of the banks volunteered for the program because they were told that they would be fulfilling their CRA requirements. *See id.* at 44–45 (statement of Michael A. Grant, President, National Bankers Association).

³³⁹ *See* Cao, *supra* note 53, at 852.

³⁴⁰ *Id.*; Anthony D. Taibi, *Banking, Finance, and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice*, 107 HARV. L. REV. 1463, 1485–89 (1994).

³⁴¹ Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 295 (1993).

³⁴² *Id.*

³⁴³ *See* Barr, *supra* note 30, at 517, 561–66, 623.

³⁴⁴ *See id.* at 603 (“CRA’s broad standards and ‘enforcement’ mechanisms . . . have long been derided by both proponents and detractors of CRA. Community advocates urge stricter rules and harsher consequences of failure. Bankers lament the lack of clear rules or safe harbors and the intrusive role of the public.”); Charles W. Calomiris et al., *Housing-Finance Intervention and Private Incentives: Helping Minorities and the Poor*, 26 J. MONEY, CREDIT & BANKING 634, 637 (1994) (stating that “the vagueness of the CRA has led to arbitrary enforcement”); Keith N. Hylton, *Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending*, 17 YALE J. ON REG. 197, 203 (2000) (explaining that enforcement of the CRA has been uneven and unpredictable); Macey & Miller, *supra* note 341, at 326–29 (describing the view that enforcement of the CRA is subjective and uncertain).

There is a robust debate about the effectiveness and appropriateness of the CRA³⁴⁵ that this Article will not engage, except to posit that regardless of its effects on low-income communities, the CRA relies on profit-maximizing banks to meet the needs of the poor. As one scholar has reasoned: “In an industry of banks of many types and sizes, without credit quotas and with institutional decisionmaking left to bank managers, the best the CRA can do is to prescribe inexact guidelines and then to ask that bureaucrats apply these guidelines to various real-world situations on a case-by-case basis.”³⁴⁶ Unfortunately, when such a mismatch of incentives exists, it will lead banks to pay more attention to their interests than the interests of the targeted customers, the poor, often resulting in damaging consequences.³⁴⁷

And because the underlying goal of mainstream banks is to maximize profits, the CRA is ripe for manipulation. During the financial crisis, there were reports that “at least in some instances, the CRA . . . served as a catalyst, inducing banks to enter underserved markets that they might otherwise have ignored,” which resulted in unfavorable loans to people in those underserved communities.³⁴⁸ “[R]ecent problems in mortgage markets illustrate that an underlying assumption of the CRA—that *more* lending equals *better* outcomes for local communities[—]may not always hold.”³⁴⁹ The CRA’s emphasis on the number of loans given, as opposed to the quality of the loans, has revealed itself to be a problematic measure of success.

The debate over the CRA implicates two broader questions about providing banking for the poor: (1) whether mainstream commercial banks should be tasked with providing these services, and (2) whether they can do it in a way that is beneficial to the poor. In other words, if a bank that attempts to maximize profits is forced by regulators to offer services to the poor, will this lead to harmful products or manipulation of regulatory loopholes? Indeed,

³⁴⁵ Compare Barr, *supra* note 30, at 513, 519, 522 (arguing that in comparison with similar regulations, the CRA has been relatively successful in addressing market failure through increased availability of lending to low-income communities), with MACEY & MILLER, *supra* note 97, and Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561, 1561, 1564–65 (1995) (suggesting alternatives to the ambiguity and ineffectiveness of the CRA).

³⁴⁶ Taibi, *supra* note 340, at 1513.

³⁴⁷ *Id.*

³⁴⁸ See Ben S. Bernanke, Chairman, Fed. Reserve Sys., *The Community Reinvestment Act: Its Evolution and New Challenges*, Speech at the Washington D.C. Community Affairs Research Conference (Mar. 30, 2007), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20070330a.htm>.

³⁴⁹ *Id.*

these banks are not equipped to meet the needs of the poor and their incentives to maximize profits run counter to the needs of the poor.

B. Community Development Banking Act

Through the Community Development Banking Act (CDBA), the idea of community-centered banks—banks that would receive funding from the government or other sources and would specialize in providing financial services to poor communities—had a short-lived resurgence. But the model has not yet succeeded because it has not escaped the mainstream ideology of banking and been fully supported by the government.

South Shore Bank in Chicago started as an experiment in which community activists bought a struggling bank and began lending in an impoverished area with apparent success in transforming the area.³⁵⁰ Bill Clinton, after visiting the bank in 1985, wanted to make it a model for low-income communities and subsequently made a campaign promise that he would establish one hundred such banks across the country.³⁵¹ The campaign promise was transformed into legislative action in 1994. The Riegle Community Development and Regulatory Improvement Act of 1994, commonly known as the Community Development Banking Act,³⁵² was intended “to promote economic revitalization and community development through investment in and assistance to community development financial institutions.”³⁵³ The Act provided for a fund that would support any Community Development Financial Institution (CDFI), which it defined as an institution that (1) has “a primary mission of promoting community development”; (2) “serves an investment area or targeted population”; and (3) “provides development services in conjunction with equity investments or loans.”³⁵⁴

Congress, however, never appropriated the full amount authorized by the CDBA for the CDFI Fund, which would have enabled government investments

³⁵⁰ Patricia Hanrahan & Katharine Rankin, *Ignoring the Homeless: An American Pastime*, HUM. RTS., Summer 1990, at 36, 37.

³⁵¹ Sharon Stangenes, *South Shore Bank Thrust into Spotlight*, CHI. TRIB., Nov. 15, 1992, § 7 (Business), at 1.

³⁵² Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, 108 Stat. 2160 (codified as amended in scattered sections of 12 U.S.C.).

³⁵³ 12 U.S.C. § 4701(b) (2006).

³⁵⁴ 12 U.S.C. § 4702(5)(A)(i)–(iii) (2006).

in community banks.³⁵⁵ The Bush Administration also sharply reduced funds to the CDFIs.³⁵⁶ These funds have never been robust or popular. In fact, the press and the banking community have largely ignored these banks because they are still relatively small in number and a large portion of the funds are dispersed among various community development initiatives.³⁵⁷ According to the Fund's financial disclosures, the majority of investments have gone, first, to real estate development in low-income communities and, second, to businesses operating in those areas.³⁵⁸ In other words, the majority of the funds have not been used to provide what the majority of the poor need, such as short-term credit.

From the start, the framework of the CDBA was stuck in the modern banking model and based on the faulty premise that these banks could maintain high levels of profitability while serving the poor. The needs of the poor would be met without any adjustment to free market rules and with minimal government intervention. It was thought that these institutions would lend profitably to low-income communities, achieve significant returns on investments, and thereby induce mainstream financial institutions to join them in providing credit to the poor.³⁵⁹ Former Treasury Secretary Lawrence Summers envisioned “[a] successful CDFI [as] perhaps best compared to a niche venture capital firm that deploys its superior knowledge of an emerging market niche to invest and manage risk better than other investors.”³⁶⁰ Summers envisioned these banks as “market scouts” that would seek out profits in overlooked markets.³⁶¹ CDFIs were meant to be private institutions seeking profits while serving the poor. Donald Lash, an early CDBA advocate,

³⁵⁵ Lash, *supra* note 77, at 397 tbl.1, 398. The Fund was also brought within the purview of the Treasury Department in 1996 and has been mentioned as one of the accomplishments of the Clinton Administration. *Id.* at 398.

³⁵⁶ See Sarah Molseed, Note, *An Ownership Society for All: Community Development Financial Institutions as the Bridge Between Wealth Inequality and Asset-Building Policies*, 13 GEO. J. ON POVERTY L. & POL'Y 489, 509 (2006); Katie Kuehner-Hebert, *CDFI Fund Appropriation Could Increase to \$100M*, AM. BANKER (N.Y.), June 13, 2007, at 4 (indicating that the Bush Administration sharply reduced funding from its peak in 2001, however, it requested an increase for fiscal year 2008); David Morrison, *Bush Administration Lowballs CDFI Fund Once Again*, CREDIT UNION TIMES, Feb. 4, 2008, at 2 (stating that the proposed budget under the Bush Administration was an almost 70% cut to the CDFI Fund).

³⁵⁷ See Benjamin et al., *supra* note 159, at 179 (explaining that the existing analysis is limited because the existing groups are so diverse and hard to classify).

³⁵⁸ *Id.* at 178–88.

³⁵⁹ Lash, *supra* note 77, at 399.

³⁶⁰ Lawrence H. Summers, U.S. Sec'y of Treasury, *Building Emerging Markets in America's Inner Cities*, Remarks to the National Council for Urban Economic Development (Mar. 2, 1998), available at <http://www.treasury.gov/press-center/press-releases/Pages/rr2262.aspx>.

³⁶¹ *Id.*

claimed that competition in banking would open the way for CDFIs to expand in response to market needs.³⁶²

Many in the banking community lauded South Shore Bank as a model of profitability as well as community-mindedness.³⁶³ Here was a bank that could serve the poor *and* make profits for its investors. The vision of the CDFI Fund was that without structural changes to the banking framework, profit-maximizing institutions could be induced through modest funds and incentives to meet the needs of struggling communities. But this was not the vision of South Shore Bank, which was started by civil rights activists in Chicago with the aim of serving the direct needs of the community and an ambitious slogan, “Let’s change the world.”³⁶⁴

Because these banks were forced to work in the dominant banking model, many have recently failed or are in trouble.³⁶⁵ In 2010, South Shore Bank was taken over after being declared insolvent.³⁶⁶ Even before the financial crisis wrought havoc on small banking nationwide, these institutions were struggling to remain profitable. Compared with their more conventional peers, CDFIs routinely show weaker financial performance. “An analysis of regulated CDFI Fund awardees found that these CDFIs typically had fewer total assets, higher loan delinquency and charge-off rates, and lower returns on assets than their non-CDFI contemporaries.”³⁶⁷ The way CDFIs operate is simply more costly than the way their traditional counterparts operate, and their objectives would be thwarted if they attempted to offset their risks with excessively high interest rates.

Part of the problem with the CDBA was that the legislation was not aspirational enough in its scope and mission. Although modeled after the bold

³⁶² Lash, *supra* note 77, at 401.

³⁶³ See, e.g., Rochelle E. Lento, *Community Development Banking Strategy for Revitalizing Our Communities*, 27 U. MICH. J.L. REFORM 773, 790 (1994) (“Shorebank presents a success story in the community development banking world. As of May 1991, its total loan portfolio was \$125 million, with a delinquency rate of 1–2%, a bit lower than the national average of 3–5%. In 1992, it had \$244 million in assets and a net income of \$1.6 million. Shorebank demonstrates that deliberate investment in disinvested communities can revive a local economy, rekindle the imagination of its people, and restore market forces to health and interdependency.” (footnotes omitted)); see also Hanrahan & Rankin, *supra* note 350, at 37.

³⁶⁴ Dave Carpenter, “*Bank with a Heart*” Thrives, SPOKESMAN-REVIEW (Spokane), June 12, 2007, at A13.

³⁶⁵ See, e.g., Robert Barba, *Deal Shows ShoreBank Was Savvy to the End*, AM. BANKER (N.Y.), Aug. 24, 2010, at 1.

³⁶⁶ See Nick Carey, *Regulators Close Well-Connected ShoreBank*, REUTERS, Aug. 20, 2010, available at <http://www.reuters.com/article/2010/08/20/us-shorebank-failure-idUSTRE67J5AE20100820>.

³⁶⁷ Benjamin et al., *supra* note 159, at 189.

vision of South Shore Bank, the CDBA was not intended to change the business of banking to meet the needs of the poor, but to fit the needs of the poor into the business of banking. Unlike the progressive and populist movements that brought about the credit union and the S&L, the CDBA movement is dependent on the current banking structure and does not attempt to subvert the institutional profit-seeking model. By offering financial incentives to mainstream banks to reach out to the poor, the CDBA expects these banks to do the heavy lifting without changing the competitive environment of banking or offering significant subsidies. Thus, the CDBA is the proverbial carrot as the CRA was the stick—both attempting to coax mainstream banks to do something inherently inconsistent with their business models.

Despite the failure of the model to expand nationwide and survive financial distress, the CDBA should be refined, not abandoned. Primarily, the CDBA model needs to escape the profit-centered ideology of modern banking to allow these institutions to function. If these banks are to continue to offer needed services to the poor, they must be able to function with minimal profits and maximum government support. Lending to the poor is not a profitable business, and the government must not outsource this important social need to the mainstream banking model. Congress must adequately subsidize this lending if it is to be effective.

C. Movements Led by the Poor

1. Informal Lending Circles

As noted above, mainstream banks and the modern banking model fail to provide appropriate services to the poor because they lack the motivation to do so. Effective banking to the poor may require that the communities themselves be involved, just as they were in the formation of the credit union and S&L. The poor know what they lack and what they need, and they should be empowered to organize movements that meet their credit needs. However, to be successful, they must have government support and access to the formal banking infrastructure.

An example of self-help financing is the lending circle model prevalent both in the United States and abroad. In the United States, undocumented workers and many immigrant groups have organized informal lending circles whereby individuals pool resources and pick a member of the group by lot to

receive a loan.³⁶⁸ These informal lending circles resemble the early credit unions and have roughly the same goal of providing credit to their members outside formal markets.³⁶⁹ These groups can overcome the informational asymmetries and transaction costs that are often the most important barriers for mainstream institutions lending credit to immigrant and poor communities.³⁷⁰

These informal lending circles resemble the microcredit model of the Grameen Bank and other international nonprofits. Multiple attempts at establishing formal microcredit ventures in the United States have been organized on the principles underlying the Grameen Bank in Bangladesh,³⁷¹ but many have suffered from setbacks and hurdles, such as lack of informal markets as well as geographical and social impediments.³⁷² Furthermore, the microcredit model is useful for small businesses and entrepreneurial ventures but is not a model that can meet the short-term credit needs of the poor.³⁷³

The communities that develop informal lending circles are usually tightly knit and share a cultural bond or language.³⁷⁴ These groups are formed on mutual trust, which is “faithful to the Latin from which ‘credit’ derives: *credere*—‘to believe.’”³⁷⁵ And belief is something mainstream lenders lack when it comes to assessing the creditworthiness of immigrants, minorities, and the poor. Thus, credit circles are designed to overcome market inefficiencies and allow capital formation and growth among tightly knit communities.³⁷⁶ Studies in New York’s Chinatown and California’s Japanese communities reveal that these institutions are the dominant form of banking among these groups. A staggering 80% of Koreans in the United States belong to at least one informal credit group.³⁷⁷ These groups optimize community wealth, do not rely on government enforcement or intrusion, and are entirely self-funded.³⁷⁸

³⁶⁸ See Cao, *supra* note 53, at 877.

³⁶⁹ *Id.* at 884–88; Light & Pham, *supra* note 50, at 39, 47 n.8.

³⁷⁰ See Cao, *supra* note 53, at 884–88.

³⁷¹ Rashmi Dyal-Chand, *Reflection in a Distant Mirror: Why the West Has Misperceived the Grameen Bank’s Vision of Microcredit*, 41 STAN. J. INT’L L. 217, 220 (2005).

³⁷² Solomon, *supra* note 28, at 206.

³⁷³ See Dean Karlan & Jonathan Zinman, *Expanding Credit Access: Using Randomized Supply Decisions to Estimate the Impacts*, 23 REV. FIN. STUD. 433 (2010).

³⁷⁴ Cao, *supra* note 53, at 843 n.6, 887.

³⁷⁵ David Bornstein, *The Barefoot Bank with Cheek*, ATLANTIC MONTHLY, Dec. 1995, at 40, 40–41.

³⁷⁶ Cao, *supra* note 53, at 887.

³⁷⁷ *Id.* at 880–81.

³⁷⁸ See CARLOS G. VÉLEZ-IBAÑEZ, BONDS OF MUTUAL TRUST: THE CULTURAL SYSTEMS OF ROTATING CREDIT ASSOCIATIONS AMONG URBAN MEXICANS AND CHICANOS (1983); Cao, *supra* note 53, at 898.

These groups are seen as alternative markets formed to deal with market imperfections, an arrangement that bolsters the dominant free market model. They operate outside the mainstream banking model as a “borrower’s solution to market imperfections, a consumer-driven arrangement that is a solution to an inherent market deficiency soluble neither by state regulation nor by open market arrangements.”³⁷⁹ These groups are an essential feature of the informal credit market and preferable to for-profit fringe banking that is currently filling gaps in the mainstream banking sector at high costs. But these alternative markets do not interact with or inform the mainstream markets.

Despite the attractiveness and desirability of such a solution to the problems facing the poor, informal lending circles are not an adequate remedy for several reasons. First, these groups do not have any formal relationship with traditional banks, which is problematic because their members are not able to develop a credit history and enter mainstream banking. Additionally, their deposits are not protected and their investments are vulnerable to fraud or mismanagement by others. Second, while these groups may be an answer for tightly knit groups of immigrants with a shared language and culture, they do not arise among the large majority of American urban and rural poor who do not share common social norms. In addition, these groups only serve those on the fringe of the mainstream markets who have community support and not the destitute or those completely cut off from any help.³⁸⁰ Third, credit is no less costly from these groups than from alternative lending sources. Members can pay up to 20% interest on loans, which means these funds are funds of last resort or necessary because borrowers lack an alternative.³⁸¹ Lastly, these groups cannot help with emergency or everyday credit needs, which continue to be the domain of loan sharks or payday loans.

2. *Formal Lending Circles*

One way to remedy some of the shortcomings outlined above is to formalize these lending circles, which was essentially the success of the credit union movement. Informal lending circles resemble the early credit unions and building and loans, but they lack the governmental support that allowed these institutions to thrive and expand. However, these lending circles can forge partnerships with banks and give their members the ability to build credit and

³⁷⁹ Cao, *supra* note 53, at 863 (emphasis omitted).

³⁸⁰ Light & Pham, *supra* note 50, at 41–42.

³⁸¹ Cao, *supra* note 53, at 877–78.

open bank accounts. One example of such an arrangement was initiated by the Mission Asset Fund (MAF) in San Francisco, which has linked a lending circle, called a “cesta,” with Citibank.³⁸² MAF serves as a credit servicer that bridges the gap between the pooled assets of the lending circle and the formal banking system.³⁸³ The fund currently serves Spanish-speaking immigrants.³⁸⁴ All members are required to have a bank account, and the payments are automatically withdrawn from the individuals’ accounts and given out electronically as well.³⁸⁵ These transactions are reported to the credit bureau, helping members build a positive credit history.³⁸⁶ The group claims a zero default rate and a successful education initiative for its members.³⁸⁷ The MAF model has received a grant from the Center for Financial Services Innovation (CFSI) and will attempt to replicate its model among Chinese immigrants, African-Americans, Middle-Eastern immigrants, and the LGBT communities in San Francisco.³⁸⁸

A formalized lending circle has the capacity to overcome some of the weaknesses in the informal lending model by formalizing these arrangements to gain the benefits of FDIC insurance and establishing credit. As mentioned above, many of the poor prefer informality in lending, and institutions that can feign informality, such as check cashers, have capitalized on this preference. The MAF attempts to do the same, but without a motive to make large profits. However, this model is limited in reach and scope. It relies on bankers’ willingness to forge these partnerships, and only a limited number of knowledgeable bankers may be altruistic enough to engage in such an enterprise. Moreover, only members can benefit from the fund, and members must commit funds to the lending circle to participate. These funds do not provide short-term credit, do not replace the services of fringe banks, and do

³⁸² See Alexa Vaughn, *Mission District Lending Circle Helps Low-Income Earners Pursue Dreams*, S.F. GATE (June 6, 2011), http://www.sfgate.com/cgi-bin/blogs/kalw/detail?entry_id=90450; *accord Lending Circles: The Program*, LENDING CIRCLES MISSION ASSET FUND, <http://www.lendingcircles.org/lending-circles/the-program> (last visited Jan. 19, 2013).

³⁸³ *Lending Circles*, *supra* note 382.

³⁸⁴ *See id.*

³⁸⁵ See Jen Haley, *The Mission Asset Fund: A Bridge Between Informal and Formal Banking*, DOWSER (Feb. 17, 2011, 11:00 AM), <http://dowser.org/the-mission-asset-fund-a-bridge-between-informal-and-formal-banking/>.

³⁸⁶ See *Lending Circles*, *supra* note 382; Jose Quinonez, *Microfinance: Bringing the Unbanked into the Financial Mainstream*, CITIGROUP (May 23, 2011, 3:27 PM), <http://new.citi.com/2011/05/microfinance-bringing-the-unbanked-into-the-financial-mainstream.shtml>.

³⁸⁷ Vaughn, *supra* note 382.

³⁸⁸ See *Bay Area Partners*, LENDING CIRCLES MISSION ASSET FUND, <http://www.lendingcircles.org/partner-with-us/current-partners/bay-area> (last visited Jan. 19, 2013).

not offer the scope of services the credit unions, S&Ls, and Morris Banks offered.

D. Post Office Banking

In addition to supporting innovative movements led by the poor themselves, policy makers should consider initiating alternative banking forms that would provide much-needed services to the large and growing unbanked population. Instead of relying on the commercial banking sector to fill the gaps in banking, government-sponsored institutions could meet these needs. As demonstrated by the credit union and S&L industries, a successful movement must be embraced by the government in order to gain trust and legitimacy. One option is to reenlist the Postal Service and use an existing, but struggling, government resource to meet a pressing policy objective.³⁸⁹ As mentioned above, the government has used the Postal Service in the past to enable the poor to open savings accounts. Post offices can be used as a way to offer short-term, low-interest credit to low-income Americans. Just like credit unions and S&Ls of the past, the Postal Service could operate through minimal government subsidies and still maintain modest profits.

The post office could offer check cashing and payday lending services much like those offered by fringe banks, but at a much lower cost. It could also offer them without all the documentation and formal barriers of banks. There are currently non-banks, other than fringe lenders, starting to offer these products because they do not involve sophisticated credit analysis or any regulatory support, such as FDIC deposit insurance. For example, Wal-Mart recently started to offer simple credit options, such as check cashing, at a discount to its customers in its stores with much acclaim.³⁹⁰ Similarly, the Postal Service could function as a basic credit intermediary. Fringe banks do not need a banking charter to offer these simple types of credit, so banking laws would not apply to such an arrangement.³⁹¹ The Postal Service would

³⁸⁹ Two other scholars have concurrent projects suggesting reenlisting the Postal Service to meet certain banking customer demands. See Adam J. Levitin, *Going Postal: Financial Inclusion via Postal Banking* (Jan. 2011) (unpublished manuscript) (on file with author) (describing the history of postal banking in the United States and suggesting the possibility of postal banking serving certain needs of the unbanked); Sheldon Garon, *A Savings Account at the Post Office*, CNN (Jan. 12, 2012, 8:38 AM), <http://globalpublicsquare.blogs.cnn.com/2012/01/12/garon-bring-back-postal-savings/> (making the case for post office savings accounts that are already in use in other countries).

³⁹⁰ Maria Aspan, *No Charter? No Problem for Wal-Mart*, AM. BANKER (N.Y.), Nov. 12, 2009, at 1.

³⁹¹ Katherine E. Howell-Best, Note, *Universal Charter Options: Providing a Competitive Advantage for State Financial Institutions*, 6 N.C. BANKING INST. 487, 511–12 (2002); see also JEAN ANN FOX, CONSUMER

need to hire trained staff and design a uniform underwriting protocol, but as demonstrated by the fringe banking industry, which makes high margins of profit by offering relatively low-risk credit, the service does not require any specialized expertise.

The U.S. Postal Service is struggling to maintain profitability and relevance as its services slowly become obsolete due to the Internet and other technological advances.³⁹² By rethinking the purpose of the Postal Service and its many existing branches, the Postal Service might be saved and a serious public need could be met. Launching such a system would certainly require up-front costs and marketing, but the costs of maintaining such a system would not have to be large. Customers would still pay a fee to cash a check, but the fee would not be as high as the fee they currently pay. Operating through the Postal Service would sacrifice some of the flexibility and innovation of the credit union and S&L movements, but the government subsidy and support would go a long way in providing access. Post offices already exist in all neighborhoods, and people of all classes and cultures have had interactions with the Postal Service. Thus, the barriers of access do not exist as they do with mainstream commercial banks.

The poor pay more for credit than any other sector of the population, and private companies profit from that spread.³⁹³ The government could step into this sector and offer lower cost credit options to the poor by only taking into account the actual cost of credit and forgoing large profit margins. For example, many members of the military currently use fringe lenders to turn their government-backed paychecks into cash. There is virtually no risk associated with a government check, but members of the military pay astronomical fees for this service. If the Postal Service could offer to turn these checks into cash and only take account of the actual costs of the credit, members of the military could take home more of their hard-earned paychecks.

FED'N OF AM., UNSAFE AND UNSOUND: PAYDAY LENDERS HIDE BEHIND FDIC BANK CHARTERS TO PEDDLE USURY 11 (2004), available at <http://www.consumerfed.org/pdfs/pdlrentabankreport.pdf>.

³⁹² Jeff Jordan, *Avoiding Financial Armageddon at the Post Office*, ATLANTIC (Oct. 29, 2012, 10:25 AM), <http://www.theatlantic.com/business/archive/2012/10/how-to-save-the-us-postal-service-through-innovation/264221/>.

³⁹³ Ian Ayres, *Market Power and Inequality: A Competitive Conduct Standard for Assessing When Disparate Impacts Are Unjustified*, 95 CALIF. L. REV. 669, 674–75 (2007) (“[T]he poor pay more’ not just because of higher costs of supply but often because sellers prey on consumers’ limited access to information and competitive alternatives. . . . [S]tudy after study has shown—in car negotiations, predatory lending, rent-to-own markets, and dozens of other contexts—that sellers are able to extract disproportionate profits from poor and disproportionately minority consumers.” (footnote omitted)); see also DAVID CAPLOVITZ, *THE POOR PAY MORE: CONSUMER PRACTICES OF LOW-INCOME FAMILIES* 18–20 (1967).

These services could be offered to the poor across the country without using banks as an intermediary.

Government-sponsored student loans operate under this premise. A student borrower who qualifies for such a loan receives credit at a lower-than-market interest rate and remains indebted to the government until the loan is paid off. The government supports such loans because they facilitate an important public objective—educating the population. Enabling the poor to escape poverty is no less important a public concern. Offering good credit to the poor would enable economic mobility—which has lagged significantly in the United States in recent years—and solve a variety of public problems.

Post office lending does not reach the level of services previously offered by S&Ls, credit unions, or Morris Banks, but it would certainly help alleviate some of the onerous costs of the fringe banking sector on the poor. And the competition provided by the government entering this sector could possibly drive prices down in the private fringe banking sector to reflect more accurately the risks of lending to the poor. Given the recent debacles of federally funded institutions, such as Fannie Mae and Freddie Mac, the federal government would have to be cautious in taking on risks associated with lending to the poor. However, these services do not entail the scope of risks associated with home mortgages. Cashing a check for a small fee or offering a payday loan often involves very little risk. And although they do not provide the access to credit that was given by the previously mentioned full-service institutions, post office banking would provide more access for services that the poor need and are currently paying too much for.

Enacting such a wide-scale change may not be politically feasible. Legislators have shown a lack of motivation to regulate the fringe banking industry in the past, mainly due to the lobbying strength of the sector.³⁹⁴ The fringe banking lobby would likely vigorously oppose government attempts to compete with the sector with the low-cost alternatives proposed here. However, after the Great Depression, President Roosevelt made significant and unpopular changes to the banking structure, like strengthening the S&L and the credit union, which made banking more accessible to the poor.³⁹⁵ These

³⁹⁴ See EDMUND MIERZWINSKI & JEAN ANN FOX, SHOW ME THE MONEY!: A SURVEY OF PAYDAY LENDERS AND REVIEW OF PAYDAY LENDER LOBBYING IN STATE LEGISLATURES 1 (2000) (highlighting success of payday lender lobby in seeking enactment of pro-industry legislation).

³⁹⁵ See Timothy A. Canova, *The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership*, 60 BROOK. L. REV. 1295, 1297–98 (1995).

changes were a response to an outcry by Americans who were suffering economically. President Roosevelt seized the economic upheaval of the 1930s to overcome similar political hurdles. A banking crisis often presents such an opportunity for enacting changes that benefit the public, and we again have the opportunity to reenvision the banking sector. The recent recession is the greatest banking crisis the United States has faced since the Great Depression and therefore presents an opportunity to change the banking structure.

CONCLUSION

“Poor people are not just like rich people without money. . . . Poverty creates an abrasive interface with society; poor people are always bumping into sharp legal things.”³⁹⁶ Thus, they cannot be banked just like rich people with less money. The poor often have different financial habits, culture, and preferences than the middle class, such as a desire for informality and a need for short-term credit. A banking structure aimed at meeting their needs would have to be responsive to these preferences if it is to successfully replace the pernicious fringe banks currently dominating financial services to the poor.

Currently, many of the poor only access the financial system through fringe banks that operate at high costs to the poor. This type of credit keeps the poor indebted with crippling interest rates for long periods of time, introducing additional barriers to their escape from poverty. The poor use these institutions because there are currently no banks designed to meet their needs. This was not always the case. In the past, the government has supported banks with a special mission of meeting the needs of the poor, such as credit unions, S&Ls, and Morris Banks.

These successful charters aimed to provide credit and access for the poor and shared a few common traits: they were born of necessity, they were created outside the dominant banking framework, they were innovative, and they had the support of the government. Yet all of these institutions have abandoned their initial missions due to structural and philosophical changes in the banking framework. This Article identifies trends in modern banking that have resulted in a homogenization of bank structures across the industry, which has left little room for banks seeking to serve disadvantaged communities. Such trends include deregulation and structural changes in the

³⁹⁶ Stephen Wexler, *Practicing Law for Poor People*, 79 YALE L.J. 1049, 1049–50 (1970).

banking sector that have caused all banks to compete with each other for higher profit margins.

Since the demise of these institutions, there have been several attempts to force mainstream banks to meet the needs of the poor—all of which have failed. Mainstream banks have been unable to offer productive products because of their unwillingness and inability to reduce profits. In order to properly serve the disadvantaged in this country, some of the more lucrative ventures must be sacrificed. But the goal is worth pursuing. Providing credit to the underprivileged can help them escape poverty in a way that rewards self-reliance. Although banking is not a right, it is a social good—not just for the low-income, but for the entire society. This Article attempts to encourage the development of banking institutions that would provide more people access to the government-subsidized banking system that already exists.

The credit union, S&L, and Morris Bank show that a bank must operate outside the mainstream banking culture as well as have the support of the government to succeed. Thus, this Article proposes several alternative banking structures that would meet the needs of the poor, such as providing more support for the CDBA system, promoting formal lending circles, or using the Postal Service to offer check cashing and payday lending services. Above all, this Article highlights the void in banking the poor and attempts to revive the public purpose of banks.